

# The Community Shares Handbook

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The definitive guide for community shares - covering all the relevant legal requirements and voluntary good practice standards for share offers

**This Handbook sets out guidance for societies and practitioners who provide advice on community shares, a term used to describe the withdrawable share capital of co-operative and community benefit societies.**

The Financial Conduct Authority (FCA) is the registrar of societies in Great Britain. The Mutual Societies Order 2013, which transferred this responsibility from the Financial Services Authority on 1 April 2013, states that “the FCA must maintain arrangements designed to enable it to determine whether persons are complying with requirements imposed on them by or under the mutuals legislation”. The FCA has the power to cancel the registration of a society if it does not comply with society legislation.

The FCA is also responsible for regulating financial promotions, but societies are exempt from most of these regulations. The FCA has a duty to ensure that community share offers do not transgress the terms of their exemption from regulation, and to encourage good practice in all forms of financial promotion, as part of its consumer protection responsibilities.

This Handbook has been produced by the Community Shares Unit (CSU), under the supervision of a Technical Committee composed of representatives from the FCA, HM Treasury, the Charity Commission, and an independent legal adviser.

Section 1 of the Handbook provides an introduction to community shares for business advisers unfamiliar with the concept. The remainder of the Handbook provides guidance on two main matters:

- The requirements of co-operative and community benefit society legislation
- Good practice relating to the promotion of community shares

The legal requirements guidance addresses matters covered by legislation or case law with which societies must comply. Where appropriate, the Handbook highlights these requirements by using the imperative ‘must’, and in some places refers to relevant legislation by name.

The good practice guidance looks at the underlying principles, ethics and standards of behaviour expected from societies offering community shares. The term ‘should’ is used when referring to these voluntary, but desirable, practices.

The CSU and FCA are working together to promote good practice by societies making community share offers. While the CSU has no formal powers to require societies to follow the guidance set out in this Handbook, it has established the Community Shares Standard Mark as a way to recognise and promote good practice. The Mark is awarded to community share offers by

practitioners who have been licenced by the CSU to carry out this work on its behalf. The Handbook is regularly updated, based on comments and feedback from practitioners, and acts as a means of sharing good practice.

Anyone can now search and explore the Handbook using the search facility and the navigation provided. You can also comment on any section to help us improve the guidance.

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## 1 INTRODUCTION TO COMMUNITY SHARES

### 1.1 EQUITY FOR SOCIAL ENTERPRISES

All enterprises need risk capital to start, to grow, and to be sustainable. This capital is usually provided by the shareholding owners of the enterprise, plus funding from lenders and, of course, from the business itself, reinvesting its profits. Risk capital allows the enterprise to ride the ups and downs of development, which are to be expected when pursuing ambitious, challenging or innovative business goals.

One of the main reasons why social enterprises can find it difficult to compete with private enterprises is their lack of risk capital. A root cause of this under-capitalisation is the belief that social enterprises cannot, or should not, have shareholders. Equity investment is considered anathema, because shares give legal title, meaning that the enterprise is owned, controlled and run in the interest of investors.

Social investment institutions have developed alternatives: quasi-equity, patient capital, and social impact bonds. But most of these products are, ultimately, a form of debt. And indebtedness is a poor form of risk capital, especially for social enterprises, where the high levels of profitability that are needed to repay debt might be incompatible with their social aims. All debts, however patient, eventually have to be repaid.

Social enterprises are defined as businesses that have “primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners”.

The purpose, objectives and behaviour of a social enterprise are enshrined in its legal form and governing document. There are many different forms of social enterprise, including charities, charitable incorporated organisations, not-for-profit companies limited by guarantee, community interest companies, co-operative societies, and community benefit societies. Each of these forms has a distinct approach to social objectives, ownership, control and capital finance.

The term “community shares” refers to non-transferable, withdrawable share capital; a form of equity unique to co-operative and community benefit society legislation. This body of corporate law provides many of the same features as company legislation, such as corporate body and limited liability status, but it also has some unique features, especially in its provisions for members and share capital.

Community shares are an ideal way for communities to invest in enterprises serving a community purpose. The remainder of this section explains how community shares work and why co-operative and community benefit society legislation is the preferred legal form for community shares, the business model underpinning community shares, and the many starting points for community share initiatives.

## 1.2 HOW COMMUNITY SHARES WORK

### 1.2.1 Origins

The term community shares was coined by the Development Trust Association (DTA) (now known as Locality) in its 2008 publication *Community Share and Bond Issues*, which examined how a growing number of community enterprises were raising investment capital from their local supporters. In the same year, Co-operatives UK published a document called *Community Investment: using industrial and provident society legislation*, addressing the same phenomenon, but focusing exclusively on societies. (The Co-operatives and Community Benefit Societies Act 2014 saw the removal of the term industrial and provident society from legislation.) It identified 39 societies that had each raised more than £10,000 in share capital through public share offers since the early 1990s, at the rate of about four new initiatives per year. Towards the end of 2008 the DTA and Co-operatives UK came together to establish the Community Shares programme, an action research partnership funded by the Cabinet Office and the Department of Communities and Local Government (DCLG). The programme ran from 2009 to 2011. Over 70 new societies registered during this period have now successfully completed a community share offer.

The Community Shares Unit was launched in October 2012. It continues as a joint initiative between Locality and Co-operatives UK, with funding from DCLG. Since 2009 over 700 new societies with the scope to issue community shares have been registered, and more than 300 community share offers have been successfully completed. In total, more than £60m of share capital has been raised from over 60,000 investors.

### 1.2.2 What are community shares?

Community shares are defined by the Community Shares Unit as non-transferable, withdrawable shares in a society with a voluntary or statutory asset lock. The term is applied to societies with at least £10,000 in share capital and at least 20 members, to focus on genuinely community owned ventures and to avoid societies offering £1 membership share only, from being classified as community shares societies. Shareholders have the right to withdraw their share capital, subject to the terms and conditions stated in the society's rules and share offer document. But they cannot sell or transfer their shares, or liquidate the business in order to achieve a capital gain.

Withdrawability solves a liquidity problem faced by any minority shareholder in a small enterprise. Shares in companies are normally transferable, not withdrawable. Under normal circumstances, companies are not allowed to redeem their shares. Instead, the shareholder must find a willing buyer for the shares, which can be very difficult for minority shareholders, especially if the company is too small to be listed on a stock market.

In solving the liquidity problem for shareholders, societies create a liquidity problem for themselves. A society must plan how it will generate the cash to allow share capital to be withdrawn. The most effective way of doing this is by attracting new members and new shareholders, to replace members and shareholders that are leaving the society. (see Section 2.3)

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### 1.2.3 Shareholder motivation

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The motivation to buy shares in a society is wholly different from the motivation to buy shares in a company. This is reflected in the differences between company law and society law, and in how these corporate forms are regulated when they seek to raise capital from the public.

The commonly accepted purpose of private enterprise is to maximise the wealth of owners and shareholders. Shareholders are motivated by the revenues they receive in the form of dividends, and by the capital gains they may achieve through any increase in the value of the enterprise. Company law caters for this by allowing companies to use their profits to pay unrestricted dividends, by giving shareholders full rights over the assets of the enterprise, and by allowing shareholders to sell or transfer their shares to a third party at a mutually acceptable price.

Social enterprises are motivated by social objectives and social purpose. For social enterprises registered as societies, this social purpose is either for the mutual benefit of members in a bona fide co-operative society, for broader community benefits in a community benefit society, or, for public benefit and charitable purpose in a charitable community benefit society. These differences in investor motivation are enshrined in society law by means of limits on the financial return on investment, asset lock restrictions on the scope for capital gains, and caps on the amount of capital an individual can invest. All of these matters are addressed in more detail below.

The primary motivation for purchasing shares in a society is to support the social purpose and objects of the enterprise. Financial motivation is at best secondary, and any return on capital is better understood as compensation rather than a reward for risk taking.

Because of these differences in investor motivation, societies are normally exempt from financial promotions regulations when promoting the sale of share capital to the public (see Section 7).

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### 1.2.4 Return on investment

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Unlike other types of business, it is not the object of a society to maximise profits for members and shareholders. The Financial Conduct Authority, which is responsible for registering societies, says that "*the declared maximum rate of interest [on share capital] is the lowest rate sufficient to obtain the necessary funds from members who are committed to furthering the society's objects*".

Section 2(3) of the Co-operative and Community Benefit Societies Act 2014 states that a "*co-operative society does not include a society that carries on, or intends to carry on, business with the object of making profits mainly for the payment of interest, dividends or bonuses on money invested or deposited with, or lent to, the society or any other person*". To be a bona fide co-operative a society must conform to the International Co-operative Alliance's (ICA) Statement of Identity, Values and Principles. The Third Principle of this Statement says that "*members usually receive limited compensation, if any, on capital subscribed as a condition of membership*".

Although the 2014 Act makes no equivalent statement relating to community benefit societies,

Section 2 (2)(ii) makes it clear that *“the business of the society is being, or is intended to be, conducted for the benefit of the community”*. This is generally taken to preclude conducting activities with the primary object of making distributable profits.

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### 1.2.5 Capital gains

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For the reasons already explained in this Section, capital gains is incompatible with the principles of community shares. The scope for a shareholder in a society to make a capital gain is either restricted or removed by two main mechanisms, the nature of withdrawable share capital, and the asset lock.

Non-transferable withdrawable share capital cannot be sold or transferred to third parties, except under special conditions where the member has died and the rules of the society allow the shares to be transferred on the death of a member. Instead, withdrawable share capital can be withdrawn from the society, subject to terms and conditions (see Section 2.2.2). This will normally be at the paid-up value of the shares, although some societies have rules that allow them to discount the value of share capital under special circumstances.

Societies can issue transferable shares, which, at least in theory, could be subject to capital gains (or losses). Transferable shareholders can sell or transfer their shares at whatever price a purchaser agrees to pay. However, transferable share capital is outside of the scope of the Community Shares Unit for reasons explained elsewhere in the Handbook (see Section 2.2.3). Charitable community benefit societies cannot issue transferable shares as this would breach charitable public benefit rules.

A capital gain could also be achieved by shareholders if the society were able to distribute residual assets in the event of the society being dissolved, or converted into some other legal form. This is restricted or prevented by the society adopting an asset lock; a rule which prohibits the distribution of any residual assets to members. Asset locks can be voluntary, prescribed by law, or have some other form of statutory basis.

A community benefit society can have a voluntary asset lock, or it can have a statutory asset lock by becoming a prescribed community benefit society (see Section 2.4). A charitable community benefit society is subject to the same asset lock requirements that apply to all charities in the UK.

The position of co-operative societies is complex. Most co-operative societies have a voluntary asset lock that prevents the distribution of residual assets to members. But there is no statutory asset lock available for co-operative societies, or any other form of statutory asset lock provision.

The ICA Statement of Identity, Values and Principles says that “at least part of [that] capital is usually the common property of the co-operative” and that co-operatives should use some of their surpluses to set up “reserves, part of which at least would be indivisible”. This implies that co-operatives should normally have at least a partial asset lock. However there is nothing in society legislation to prevent a co-operative society from converting into a company, which in turn would enable it to distribute residual assets to members.

Whereas capital gains is incompatible with community shares, the growth in members' shareholdings is a common occurrence in societies that credit share interest payments to members share accounts. This form of reinvestment may be an important component in the capital liquidity provisions of a society (see Section 2.3).

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### 1.2.6 Shareholder influence

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Shareholders and members of societies are restricted in the amount of influence and control they can exercise individually. This is achieved through two legal mechanisms. Societies are required to state in their rules how decisions will be made at general meetings. Bona fide co-operative societies are required to work to the co-operative principle of one-member-one-vote, regardless of the amount of share capital held by an individual. Society legislation makes no provision for voting arrangements to be allocated on the basis of shareholdings, so the principle of one-member-one-vote also applies to all community benefit societies by default.

The other way in which shareholder influence is restricted is by placing a legal limit on the maximum amount of withdrawable share capital an individual may hold in a society. This limit is set at £100,000. This maximum limit prevents a society from being overly dependent on large investors. A society can choose to adopt a lower maximum limit in its rules or share offers, which is advisable for smaller societies, where £100,000 could be a significant proportion of the total capital they require (see Section 3.2.7).

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### 1.2.7 Community interest companies

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Community interest companies (CICs) can, and do, sell shares to investors and raise capital from the communities they serve. But they must do this in a way that is completely different from societies.

CICs are a regulated form of company. As such they are fully subject to company law, plus the specific provisions of the CIC regulations. CIC legislation, introduced in 2005, provided a new regulatory framework governing the three main forms of company: a private company limited by shares, a company limited by guarantee, and a public limited company (plc).

Section 755 of the Companies Act 2006 prohibits private companies from making public share offers. This means that any company planning to make a public offer of its securities must convert to a plc before making the public offer. This includes CICs, which must become CIC plcs. Public limited companies are required to have a minimum of £50,000 in paid-up share capital and must meet more stringent auditing and public reporting standards. The Financial Promotion Order 2005 (see Section 7.3.3) requires financial promotions to be overseen by an FCA authorised person, unless the promotion is exempt from these provisions. The Order specifies a range of exemptions, including an exemption for societies, but not for CICs. Other exemptions, which may be relevant

for CICs, include high net worth individuals, sophisticated investors, and the 'common interest group' of a company. However, professional advice should typically be sought to determine how these exemptions might apply in the circumstances of a proposed share offer by a CIC.

There are also financial and governance reasons why CICs may not be a straight forward form for community shares. Unlike societies, companies cannot issue withdrawable shares; their shares must be either transferable or redeemable, which requires a different approach to capital liquidity. On the other hand, there are no restrictions on the amount of share capital an individual may hold in a CIC. The dividend cap on CICs may allow investors a higher return on capital than can be offered on shares in societies, as it is based on a proportion of profits (currently 35%) rather than a dividend rate per share.

Although the CIC form may not be straight forward for community investment, it is still a suitable form for equity investment by social investors. It may be particularly suited to social investors who want to exercise control over their investment, because CICs work to the principle of one-share-one-vote. The private placement of CIC equity with social investors could in turn be facilitated by social investment financial intermediaries who understand the constraints of the Financial Promotion Orders and have access to sophisticated investors and high-net-worth individuals. For CICs who are seeking to attract investment, and there are a number who have done this successfully, it is recommended they look for specialist advice or networks for further guidance.

### 1.3 THE BUSINESS MODEL

Investing in community shares engages communities in a virtuous circle where it is in their interests as members and investors to also be active as customers, as supporters, and as volunteers. The same applies to other stakeholders, including employees and suppliers, giving new meaning to the term multi-stakeholder, where the same person engages with the enterprise through a multiplicity of stakeholder roles.

This is in contrast to the conventional business model, where the interests of shareholders are at odds with other stakeholders. Profit maximisation for shareholders is at the cost of customers, suppliers, employees and other investors. There is no incentive to volunteer, or to become an active supporter of an enterprise that works in someone else's interests.

Community shares promote a different sort of business model, where it is in the interests of all stakeholders to work together to create wealth and to use their democratic rights to determine how that wealth is distributed. It is in the mutual interests of all stakeholders to become members and investors, not just when the society is established, but on a continuing basis as the enterprise grows and develops. New customers, suppliers and employees can be encouraged to become members and investors, to replace the share capital being withdrawn by older members when they leave the society.

Community shares relies heavily on community engagement; the involvement of people in the life of the enterprise. Societies need to define their target communities, and to develop the identity of these communities. Most communities are geographic in nature, but it is not always obvious where the boundaries of geographic communities lie, and whether people within that community have a

shared identity.

Community identity can transcend geography and focus instead on shared interests, values, concerns, or beliefs. Examples include a shared interest in renewable energy, local food production, affordable housing, support for a football club, or community services provided by a faith group.

Community shares can provide an enterprise with a competitive advantage by engaging stakeholders in new responses to the causes of market failure. For instance, many small businesses fail because the owner is unable to find a buyer willing or able to purchase the business. Communities can spread the cost and risk of acquisition across a large number of shareholders. A business might be failing through a lack of demand; communities can address this by aggregating demand and ensuring that the business serves the community. A business might be unable to control costs resulting in unaffordable prices; a community can reduce costs by volunteering, or by providing cheaper capital.

## 1.4 STARTING POINTS

### 1.4.1 The initial stimulus

Since the inception of the Community Shares programme in 2009, more than 90% of community share offers have been made by new societies. Most of these societies have been formed by communities in response to one or more of the following:

- a community is about to lose a local service, for instance, a pub, shop or post office, or any other community service that is encountering market failure
- a community is being poorly served by an existing enterprise, for instance, supporters of a football club may feel that the current owners do not serve their interests, or a local service is too expensive or fails to address local needs
- a community need or interest is not being met, for instance, there may be no local sports facilities, poor broadband connections, or a lack of flexible workspaces for new businesses
- a community is inspired by new ideas or opportunities to act collectively, for instance, by the scope to establish community renewable energy schemes, local food initiatives, or develop community land trusts for affordable housing.

These stimuli result in new societies being formed as pre-start initiatives, or to act as the vehicle for acquisitions and buy-outs of existing enterprises that are failing in these communities.

### 1.4.2 Pre-start initiatives

There are four main challenges facing all community enterprise pre-start initiatives:

- developing a robust, competent development team capable of taking the idea forward to start-up
- establishing the business case for the proposed enterprise; testing the business viability of the idea and showing that the enterprise will be profitable; ensuring that the proposed development

is in scale with the target community

- identifying the target community for the initiative; establishing contact with this community, and winning their support for the initiative; engaging the community in the development process
- obtaining the resources to pay for the pre-start development costs, which can amount to at least 5% to 10% of the capital costs at start-up.

A lack of resources is probably the greatest barrier for pre-start initiatives, with some new societies taking three or more years to become investment-ready.

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### 1.4.3 Acquisitions and buy-outs

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Acquisitions and buy-outs mainly arise when a community is driven to rescuing a local business threatened with closure or, in exceptional circumstances, where the community feels poorly served by the business. Communities engaged in acquisitions and buy-outs face all the same challenges as pre-start initiatives, but with the extra burden of:

- having to act quickly, especially if there is competition to buy the business or its principal assets
- having to commit to development costs with no certainty that it will be successful in acquiring the business, with the risk of substantial losses
- the difficulty of agreeing a fair valuation for the business, especially when the principle assets are worth more as non-business assets.

The first of these challenges can be moderated by using the powers included in the Localism Act to list Assets of Community Value. This gives communities six months in which to prepare a bid to purchase a listed asset if it is put up for sale.

Compared with a new-start enterprise, an advantage of acquisitions and buy-outs is that at least the business in question has a track record, which provides a benchmark for planning performance improvements.

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### 1.4.4 Start-ups

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Even when a new enterprise has got through the pre-start stage and is able to prove that it is investment-ready, there is still a lot to do before it can launch a community share offer. There are four main documents it needs to have in place:

- a governing document that sets out the rules of the society, defining its purpose, objectives, membership, management and form of share capital
- an offer document aimed at the target community promoting the sale of share capital; community share offers are normally exempt from financial promotions regulations, but are nevertheless bound by contract law to observe good practice and follow guidance on these matters
- a business plan that provides the evidence to support the assumptions and assertions made in the offer document
- a community engagement plan for recruiting members to the society, involving them in the business model, and securing their investment.



Community share offers are markedly different to share offers made by private enterprise, in the following ways:

- Private enterprises usually only make public offers at a relatively late stage in their development, typically as part of an exit strategy for private equity. In contrast, community share offers tend to be made by new enterprises with no proven record of success.
- New private enterprises usually raise share capital from family, friends, business angels and other types of sophisticated investor, whereas community share offers are aimed at people who are unlikely to have had any prior experience, knowledge or competencies in investing in enterprise.
- Start-up private enterprises tend to raise share capital through private placements, which might lead to a handful of investors purchasing stakes in lots of £50,000 to £100,000. In contrast, the average number of investors in a community share offer is 200 and the average amount invested is £1,000 per investor.

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### 1.4.5 Established social enterprises

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A survey by Social Enterprise UK found that the most commonly held objective of social enterprises is community improvement, cited by 25% of respondents. But only a handful of these social enterprises have taken advantage of what community shares have to offer in terms of capital finance and community engagement. Many social enterprises are structured as registered charities or companies limited by guarantee, neither of which can issue share capital. However, as Section 2.6 explains, both types of organisations can be converted into societies without any change to their objectives.

Research commissioned by Power to Change in 2016 estimates there are 7,085 community business in England. The research identifies specific market sectors community businesses are engaged in, some of which are also heavily represented by societies issuing community shares, such as community energy, shops and pubs. It also identifies market sectors where there has been relatively little community shares activity, such as village halls, transport, housing, sports, leisure and libraries, as well as arts centres and facilities, parks, health and social care. These sectors represent an important opportunity for the growth of community shares.

Some of these sectors, notably housing and sports, include many long-established community enterprises that are structured as societies. There are more than 8,000 societies in the UK that are over 10 years old, but only 40 or so of these societies have ever issued significant amounts of withdrawable share capital. This includes over 1,500 societies in the housing sector and more than 400 societies in the sports sector. Very few established societies use the full scope of their corporate form to engage the communities they serve, and it may well be that very few of these societies fully appreciate the capability their corporate form offers for simultaneously raising investment capital and engaging their communities.

## 1.5 INSTITUTIONAL INVESTMENT

Community shares can provide the foundations for building a robust capital structure in a society. Some societies may be able to raise all the capital they require from individual members. But, more often than not, community shares act as a lever to access institutional investment. This investment

might be in the form of grants, loans or equity. The institutions might be public funding bodies, social investment specialists, banks, ethical investment funds, charities, and corporations, including other societies.

Institutional investment is defined here as investment by institutions that exceeds the limits voluntarily imposed on individual shareholdings by members, usually 10% of the share capital of the society. The purpose of voluntary limits is to prevent societies being overly dependent on individual members. Where an institutional investor is providing more than 10% of the capital of the society, safeguards need to be established to protect the interests of ordinary members. Institutional investors often take comfort from community shares. Community shares demonstrate community support for the enterprise, and its services. It provides some financial security for institutional lenders, knowing that they are higher up the list of creditors than shareholders. It is proof of the long-term commitment by members to make a success of the enterprise and to see it through any difficult or challenging period.

Institutional investment is usually welcomed by societies, subject to concerns about the impact it might have on members' investment and the dangers of over-dependency on a single source of investment. These concerns depend on both the nature and the scale of the investment. The focus here will be on three types of institutional investment - grants, loans and equity – and on a scale range from 10% to over 90%, of total capital required.

Institutional grant funding generally poses little concern, especially when it is public funding for public interest initiatives. Dependency on grant funding is less of a problem when the grant is for capital purposes, rather than revenue activities of the society. Capital grants have a positive impact on societies by lowering the cost of capital. Even when a capital grant exceeds 90% of the total capital required, it is unlikely to have an adverse effect on a society, unless it diminishes the motivation of the local community to become members and investors in the society, or it leads to a society taking on a capital investment project that is much larger than it can support in revenue terms.

By comparison, institutional lending poses a number of concerns and should be treated with caution, whilst recognising that debt is an essential part of the funding mix for most businesses. Approached correctly, lending can be flexible, responsive, and in some cases cheaper for a society in the long run. Institutional lending to societies generally takes three forms; secured longer-term capital finance for fixed assets, shorter-term finance for working capital, and bridging loans. Other forms of debt finance, such as overdrafts, factoring and corporate credit cards, are not considered here.

Secured longer-term capital loans, for terms of five years or more, are typically used to finance the purchase of fixed assets, where community share capital and the resale value of the fixed assets are seen to reduce the risk of the lender. Lenders may be willing to lend up to 80% of the total capital required by a society, especially for a fixed asset such as property that is unlikely to depreciate quickly in value. Payment of interest and repayment of capital for secured loans takes priority over any payment to shareholder members, or to unsecured creditors such as suppliers. The payment of loan interest will reduce the amount of surplus available for community benefit, share interest and withdrawal. Loans may also be more expensive than community shares. High proportions of secured debt in the overall capital financing package will increase the effect of these drawbacks for

a society.

Shorter-term loans, for up to five years, are usually made to provide working capital, enabling a society to purchase stock, or meet staffing costs in the early start-up phase of a society's operation. This form of lending provides a safety net for societies that have unpredictable or large fluctuations in their cash flow requirements, or simply lack cash when they start. Such loans should be restricted to an amount the society can realistically repay from cashflow within the lifetime of the loan.

Finally, some institutions may be prepared to provide bridging finance. Such finance can help societies that need to act quickly to secure the purchase of fixed assets, or where they might be involved in a competitive bid for the assets, and do not want to publish a community share offer providing full details of their capital plans. Alternatively, finance may be needed to fill a temporary cashflow deficit caused, for instance, by VAT payments or delays grant funding. Bridging loans are so called because they bridge a gap in finance, so are usually very short term, and comparatively expensive. In the context of community shares, bridging loans are usually replaced by the proceeds of a successful community share offer. The society needs to be confident that the problem is only temporary, or that it will be able to raise sufficient community share capital to replace, or reduce, the bridging loan to a viable level.

All forms of debt finance will usually be subject to legal agreements which may contain covenants that restrict the freedom of the society. The two most common covenants are to establish security over a society's assets, and to require directors to seek permission from the institutional lender before entering into any further debt finance agreements.

Societies should be cautious of accepting loans for more than 50% of their total capital requirements. For loans of between 25% and 50% of their total capital requirements, caution should also be exercised if the cost of the loan is significantly above the maximum interest rate payable on community shares, and or where the lender requires full capital repayment in less than five years. In such circumstances a society's members and prospective members should be fully informed about how the loans might affect their financial interests.

Debt finance can be highly effective in addressing any shortfalls in funding raised through a community share offer. Section 4.5.4 recommends that societies making a time-bound offer set three fundraising targets; a minimum, an optimum, and a maximum amount. Debt finance can be used to fill the gap between the amount raised and either the optimum or maximum fundraising target. However, this can only be done if the lender agrees to adjust their loan to fill any shortfall from the targets. Some institutional investors may want to charge a higher fee for making such an arrangement, to ensure that their costs are covered.

In comparison to loans, institutional investment in the form of equity, is usually a better option for societies, especially if institutional investors accept the same terms and conditions on their shares as individual members. Sections 3.2.7 and 4.5.6 recommend that the maximum amount of share capital held by individuals should be voluntarily limited to no more than 10% of the total capital required, if this amount is less than £1m. The legal maximum limit for individual holdings of withdrawable share capital in a society is £100,000. This limit does not apply to societies investing in the share capital of other societies. So, if an institutional investor wanted to invest more than

£100,000 in the share capital of another society, it would need to be structured as a society, with the requisite powers to invest in other societies.

Where it proposed to allow an institution to purchase more shares than the voluntary maximum limit, the society should adopt the following procedure. If the institutional investor is seeking preferential terms of withdrawal or share interest, these terms must be clearly stated in the offer document. If this offer is being made by an established society, with existing member shareholders, then the society should seek their members' approval before offering these preferential terms. In all instances, societies should seek to recruit at least 20 members, the minimum number of members required to justify the term community shares (see Section 1.2.2).. For a new society with fewer than 20 members, it is sufficient to set out the terms of the agreement with the institutional investor in the offer document. Prospective members can then decide for themselves whether the agreement is acceptable.

If the institutional investor is prepared to accept equal terms to other members, then it is sufficient for the society to simply state this in its offer document, noting what proportion or amount the institutional investor may invest. As a matter of good practice, societies should give preference to ordinary members over institutional members if the offer is over-subscribed. This needs to be agreed in advance with the institutional investor.

Institutional investors agreeing to equal terms should limit their requests for withdrawals to an amount no more than the maximum any other member may request, or may be granted. So, if a society has a voluntary maximum shareholding limit this would also be the maximum amount that an institutional investor could apply to withdraw. If the amount of share capital available for withdrawal is restricted, then institutional investor should only be allowed to withdraw capital on the same restricted terms as other members.

For example, if a society is seeking to raise a maximum of £250,000 in community shares, it should adopt a voluntary maximum shareholding limit of £25,000. Institutional investors may be allowed to invest up to the legal maximum of £100,000 or more if it is also a society with the powers to make this sort of investment. However, unless the institutional shareholder has agreed preferential terms with the society, it should agree to limit withdrawals to £25,000 in any one period, if it has invested more than this. If the society has received requests for withdrawals exceeding the amount it has available for withdrawal in that period, then it should devise a fair way of rationing withdrawals that should be applied equally to all withdrawal requests.

Where a society is using an open offer to generate liquidity to fund share withdrawals, any preferential terms held by institutional investor members should be made clear to applicants in the offer document.

## 2 SOCIETY LEGISLATION

### 2.1 TYPES OF SOCIETIES

#### 2.1.1 Introduction

The Co-operative and Community Benefit Societies Act 2014 came into force on 1 August 2014, consolidating and replacing previous industrial and provident society legislation, including the Industrial and Provident Societies Act 1965, which has been renamed the Co-operative and Community Benefit Societies and Credit Unions Act 1965.

It should be noted that the new 2014 Act does not apply to Northern Ireland, where an amended form of the Industrial and Provident Societies Act (Northern Ireland) 1969 still applies, although it is subject to change under new legislation, the Credit Unions and Co-operative and Community Benefit Societies Act (Northern Ireland) 2016. This new Act amends and renames previous society legislation in Northern Ireland, but unlike the 2014 Act, it does not consolidate society law. On 6 April 2018 the responsibility for registering co-operative and community benefit societies in Northern Ireland moved from the Department for the Economy (DfE) to the Financial Conduct Authority (FCA). As a consequence of this change, societies in Northern Ireland will now have to pay a periodic fee when filing their annual returns with the FCA.

A major consequence of the 2014 Act is to create two categories of society:

- Societies registered prior to 1 August 2014
- Societies registered under the new Act from 1 August 2014 onwards.

Societies registered under the new Act are registered specifically as a co-operative society or a community benefit society (including a charitable community benefit society). Prior to 1 August 2014, a society had to have the characteristics of either a co-operative society or a community benefit society, but it was not registered as a specific type of society. The FCA, and its predecessor registration bodies, kept no record of what type of society was being registered. A society registered before 1 August 2014 is referred to as a pre-commencement society by the FCA, and it must describe itself as either a "registered society" or a "society", on its business stationery; it must not refer to itself as a co-operative society or a community benefit society. A registered society that wants to refer to itself as a specific type of society on its business stationery must register a new society and transfer its engagements to this new society (see Section 2.7).

The 2014 Act brought in other significant changes, including a maximum limit of £100,000 on individual shareholdings of withdrawable share capital, new procedures for societies facing insolvency, and new additional powers for the FCA to investigate societies.

In Northern Ireland, the 2016 Act introduced some, but not all, of the changes created by the 2014 Act in Great Britain. Principal among these changes was the introduction of a new maximum limit of £100,000 on individual shareholdings of withdrawable share capital, and changes to the age limits that apply to members and directors of societies. Both changes came into force in June 2016. Other changes relating to annual returns, unaudited accounts, dissolution and other minor

matters, came into force in April 2016. Some changes, such as the renaming of the 1969 Act as the Credit Unions and Co-operative and Community Benefit Societies (Northern Ireland) 1969 Act, and the introduction of two new legal forms, a co-operative society and a community benefit society, have yet (as of May 2017) to come into force.

In November 2015, the FCA published its finalised guidance on its registration function under the 2014 Act. This followed a lengthy period of public consultation into proposed changes to its guidance, in the light of these legislative changes, and other concerns about current practice.

This Handbook focuses on three main types of societies: bona fide co-operative societies, community benefit societies, and charitable community benefit societies. There are other types of society, including credit unions, building societies and friendly societies, but these are subject to separate legislation and are outside the scope of this Handbook.

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## 2.1.2 Bona fide co-operative societies

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The 2014 Act does not define or describe what a bona fide co-operative society is. In the absence of a statutory definition, the FCA provides guidance on how it determines whether a society is a bona fide co-operative. It uses two tests, outlined in the following paragraphs.

Section 2(3) of the 2014 Act states that a *“co-operative society does not include a society that carries on, or intends to carry on, business with the object of making profits mainly for the payment of interest, dividends or bonuses on money invested or deposited with, or lent to, the society or any other person”*. The FCA registration guidance makes it clear that it will use this section of the Act as part of its determination of whether a society can be registered as a co-operative, and can remain registered as a co-operative. The FCA will do this by inspecting the proposed rules, rule changes, application forms, annual accounts and other published information, which presumably could include a community shares offer document. This approach to defining a co-operative society does not mean that a co-operative cannot distribute its surpluses to members; a matter more fully addressed in Section 6 of the Handbook.

The second test used by the FCA is based on the International Co-operative Alliance’s *Statement on the Co-operative Identity, Values and Principles*, which defines a co-operative as “an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically controlled enterprise.”

The FCA use this definition to determine whether a society is a bona fide co-operative. It also uses the values and principles, presented below, to verify and validate whether a society’s rules and governance arrangements are consistent with those of a co-operative.

**Values** *Co-operatives are based on the values of self-help, self-responsibility, democracy, equality, equity, and solidarity. In the tradition of their founders, co-operative members believe in the ethical values of honesty, openness, social responsibility, and caring for others.*

**Principles** *The co-operative principles are guidelines by which co-operatives put their values into*

practice.

1. **Voluntary and Open Membership:** *Co-operatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political, or religious discrimination.*
2. **Democratic Member Control:** *Co-operatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary co-operatives, members have equal voting rights (one member, one vote) and co-operatives at other levels are also organized in a democratic manner.*
3. **Member Economic Participation:** *Members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually the common property of the co-operative. Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership.*
4. **Autonomy and Independence:** *Co-operatives are autonomous, self-help organizations controlled by their members. If they enter into agreements with other organizations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their co-operative autonomy.*
5. **Education, Training, and Information:** *Co-operatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their co-operatives. They inform the general public – particularly young people and opinion leaders – about the nature and benefits of co-operation.*
6. **Co-operation amongst Co-operatives:** *Co-operatives serve their members most effectively and strengthen the co-operative movement by working together through local, national, regional, and international structures.*
7. **Concern for Community:** *Co-operatives work for the sustainable development of their communities through policies approved by their members.”*

The FCA expects to see principles 1 to 4 expressed in the rules and governance arrangements of a society, whereas principles 5 to 7 are more likely to be expressed in the policies and actions of a society. The FCA registration guidance places a particular emphasis on the associative characteristics of co-operative societies, focusing on the relationships between members. The purpose of a co-operative society is to serve the interests of members. It can distribute part of its surpluses or profits to members in the form of a dividend on their transactions with the co-operative. The FCA recognises the diverse nature of co-operative enterprise, and the many different arrangements between members for serving their mutual interests, based on co-operative principles. Co-operative societies are free to determine who can be a member, based on the principle that it should be open to all who can use the services of the enterprise. The involvement of non-user members is subject to specific FCA guidance on the matter.

In Northern Ireland where the Industrial and Provident Societies (Northern Ireland) Act 1969 still applies, there is no distinction between different society forms.

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### 2.1.3 Community benefit societies

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The purpose of a community benefit society is to serve the broader interests of the community, in contrast to co-operative societies that serve the interests of members. The 2014 Act requires a community benefit society to “carry on a business, industry or trade” that is “being, or intended to be, conducted for the benefit of the community”. But the Act does not provide any further definition or description of what a community benefit society is, creating a reliance on the FCA’s registration guidance. The FCA focuses on four key characteristics of a community benefit society:

**Purpose:** The FCA says that “the conduct of a community benefit society’s business must be entirely for the benefit of the community.” There can be no alternative or secondary purposes, including any that may preferentially benefit the members.

**Membership:** In common with all societies, community benefit societies normally have members who hold shares and are accorded democratic rights on the basis on one-member-one-vote. The FCA says “it is not usually appropriate for a community benefit society to give any particular group of members greater rights or benefits, because the society must be conducting its business for the benefit of the community. So, for example, we would expect to see community benefit societies run democratically on the basis of one-member-one-vote.”

**Application of profits:** Any profit made by a community benefit society must be used for the benefit of the community. Unlike a co-operative society, profits cannot be distributed to members of a community benefit society. Interest on share capital is an operating expense and should be subject to a declared maximum rate (see Section 6 for more details).

**Use of assets:** Community benefit societies must only use their assets for the benefit of the community. If a community benefit society is sold, converted, or amalgamated with another legal entity, its assets must continue to be used for the benefit of the community and must not be distributed to members. This lock on the assets of a community benefit society can be reinforced by adopting the prescribed wording for a statutory asset lock (see Section 2.4).

The FCA registration guidance acknowledges that a community benefit society might define the community it serves, but this should not inhibit the benefit to the community at large, in other words, community benefit should not be restricted to members only. The FCA does not provide guidance on who can be a member of a community benefit society. In the context of community shares, it is assumed that membership is open to any person who supports the purpose of the society, without the distinction found in co-operative societies between user and non-user members. Normally, the FCA would expect members to be granted democratic control, based on one-member-one-vote, but it may be prepared to register societies where control has been ceded to a parent body, if that parent body can show that it can run the society for the benefit of the community.

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### 2.1.4 Charitable community benefit societies

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A charitable community benefit society is a community benefit society with exclusively charitable purposes. The recognition and regulation of charities is a devolved matter. In England and Wales,



the Charity Commission for England and Wales provides guidance on what constitutes a charitable purpose, based on the Charities Act 2011, which sets out 12 main charitable purposes plus any other purposes that can be recognised as charitable under existing law. (For further information see [www.gov.uk/running-charity/setting-up](http://www.gov.uk/running-charity/setting-up))

In Scotland, the Scottish Charity Regulator provides guidance on what constitutes a charitable purpose, based on the Charities and Trustee Investment (Scotland) Act 2005. (For further information see [www.oscr.org.uk/charities/becoming-a-charity](http://www.oscr.org.uk/charities/becoming-a-charity))

The Charity Commission for Northern Ireland may take a different view on charitable community benefit societies to those expressed in this Handbook.

A charitable community benefit society must only undertake activities that further its exclusively charitable objects. This means that a charitable community benefit society that intends to engage in trading activities that are neither in pursuit of its primary purpose nor ancillary to that purpose, may have to establish a trading subsidiary to carry out this trade.

A charitable community benefit society must have an asset lock. This must take the form of a rule stating that if the society is dissolved, any residual assets must be transferred to another charity with the same or similar charitable purposes. The asset lock rules prescribed by the Community Benefit Societies (Restriction on the use of assets) Regulations 2006, and the equivalent regulations in Northern Ireland, cannot be used, as they do not give exclusive rights to charities. (This matter is dealt with in greater detail in Section 2.4.)

In England and Wales a charitable community benefit society cannot register as a charity with the Charity Commission. Instead it must apply to HMRC to be recognised as an exempt charity for tax purposes. The Charities Act 2006 introduced changes to how exempt charities are regulated, and required all exempt charities to have a principal regulator. However, a principal regulator has yet to be appointed for charitable community benefit societies that are not registered social landlords. (For further information see: Charity Commission, C23 Exempt charities.)

A charitable community benefit society may include the words 'charity' or 'charitable' in its name if it has obtained prior permission from the relevant authorities (see Section 3.2.1). The Charity Commission will only agree to the use of these words by entities it considers to be charitable. Exempt charities are entitled to the same tax benefits as registered charities. These include relief from income tax, corporation tax and capital gains tax, exemption from inheritance tax and relief from business or non-domestic rates.

In Scotland, there is no such term as the 'exempt charity' and therefore to be a charitable community benefit society the society must also apply to the Scottish Charity Regulator to be registered charity. To obtain tax benefits the organisation will also have to apply to HMRC. The same is true in Northern Ireland, where charitable community benefit societies must become registered charities with the Charity Commission for Northern Ireland, and apply separately to HMRC for tax benefits.

Both The Charity Commission and the Scottish Charity Regulator have acknowledged that charitable community benefit societies may issue community shares and pay members interest

on share capital, subject to a number of conditions. (See Section 6.5 for further details.)

When registering a new charitable community benefit society, information must be provided about the charity's trustees. This includes their full name, contact details, occupation, date of birth and signature. The FCA checks that the persons named are not disqualified from acting as charity trustees. However, the FCA does not grant exempt charity status, this is a matter addressed by a separate application to HMRC.

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## 2.1.5 Choosing between society types

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The three types of societies serve three different groups of beneficiaries. Co-operatives are for member benefit, community benefit societies are for community benefit, and charitable community benefit societies are for public benefit. There are important yet subtle distinctions between member, community and public benefit. The concept of public benefit is central to charitable law, and focuses exclusively on charitable objects, whereas community benefit is neither necessarily, nor exclusively, charitable. Member benefit in a co-operative society is shaped by co-operative values and principles, which distinguishes it from the private benefit of company shareholders.

All three types of society have their pros and cons. Co-operatives have the scope to distribute profits to members in the form of a dividend based on the level of their transactions with the co-operative, which can incentivise member loyalty and strengthen the business model. Community benefit societies with a statutory asset lock may provide greater reassurance to public funders and grant-giving bodies, while still affording such societies the freedom to engage in a wide range of business activities and are not restricted to pursuing charitable objects. Charitable community benefit societies enjoy all the tax benefits that apply to charities, but are restricted to exclusively charitable purposes.

Co-operatives might have greater appeal to members who are attracted by the benefits of mutuality and community; community benefit societies might be more appealing to members who put wider community benefit before their mutual interests. Only co-operative societies have the scope to distribute surpluses to members in the form of a dividend on members' transactions. The option to pay dividends is a prudent way of managing the finances of a society, and for encouraging member loyalty.

All three types of society can have an asset lock, a defining feature of community shares according to CSU policy. A charitable community benefit society must have a statutory asset lock, defined by charity law, whereas a community benefit society can choose between a statutory asset lock and a voluntary asset lock. A co-operative society can choose to adopt a voluntary asset lock, although there is no requirement to do so, and the FCA does register co-operative societies without this feature.

Choosing between a co-operative society or community benefit society structure is important because, while it is possible to convert a co-operative into a community benefit society, it is not

possible to convert a community benefit society into a co-operative, or for a charitable community benefit society to simply cease being a charity.

In the UK, a co-operative can take any legal form, as long as its governing document enshrines the co-operative values and principles laid out in the ICA Statement of Identity, Values and Principles. Many community benefit societies embrace co-operative values and principles and are co-operative members of Co-operatives UK.

## 2.2 SHARE CAPITAL IN SOCIETIES

### 2.2.1 Share typologies

Co-operative and community benefit societies can issue shares that are transferable or non-transferable, and withdrawable or non-withdrawable. For the purposes of this Handbook, non-withdrawable, non-transferable shares are referred to as membership shares. Community shares are withdrawable, non-transferable shares in a society with a voluntary or statutory asset lock. Transferable shares, be they withdrawable or non-withdrawable, are outside the scope of the Community Shares Unit for the reasons explained in Section 2.2.3. The Charity Commission for England and Wales and the Office of the Scottish Charity Regulator have accepted that a charitable community benefit society can issue withdrawable shares, but it has not considered whether it would be acceptable for such a society to issue shares that were transferable. Currently, there is no legal provision for societies to issue redeemable shares, which are unique to company law

In addition to there being different types of shares, a society can issue more than one class of share of the same type, with different rights attached to each class, clearly stated in the rules of the society. Membership and voting rights are normally attached to share capital, although some societies with multiple classes of shares, issue shares that do not carry voting rights. This is explored in more detail in Section 2.2.6.

Regardless of which type of shares a society issues, it is normal for all three types of society to practice member democracy, based on the principle of one-member-one-vote, rather than one-share-one-vote, which is the default position of company law. The Co-operative and Community Benefit Societies Act 2014 has nothing to say about how voting rights are allocated in a society, although the new FCA registration guidance makes it clear that it expects all types of society to adopt the principle of one-member-one-vote, as a condition of registration.

### 2.2.2 Withdrawable shares

Community shares are non-transferable, withdrawable shares in a society with a voluntary or statutory asset lock. Members are allowed to withdraw this type of capital, subject to the rules of the society. The rules can specify the terms for withdrawal, such as a period of notice of the intention to withdraw, the proportion of total share capital that can be withdrawn at any one time, as well as the right of the management committee to suspend withdrawal or to offer applicants only a fraction of the value of their share capital.

International accounting standards require that if withdrawable share capital is to be recorded as equity for accounting purposes, the society must have the discretionary powers to suspend or refuse withdrawal clearly stated in its rules. If a society does not have these powers, then withdrawable share capital must be treated as a long-term liability.

There is a legal limit on the amount of withdrawable share capital that can be held by an individual member, currently standing at £100,000. The purpose of the limit is prevent a member having undue financial influence, or for the society to be overly dependent on a small number of members.

Withdrawable shares are not normally transferable, unless a member dies, in which case their shares are transferred as part of the member's estate. Society legislation makes specific provision to allow members to nominate the person or persons who will benefit from their property in the society, including withdrawable share capital.

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### 2.2.3 Transferable shares

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Transferable shares are shares that can be traded between buyers and sellers at a mutually agreed price. Any type of society is free to issue transferable shares, as long as provision has been made for this in its rules. Transferable shares cannot be withdrawn from a society, unless the rules state otherwise. As such, transferable share capital is part of the permanent capital of the society, freeing it from any responsibility to make provision for liquidity. Instead, it is the responsibility of the shareholder to find a buyer if they want to realise the value of their shares. Since 2012 there has been no upper limit on the amount of transferable share capital an individual can hold in a society.

The FCA's registration guidance requires any society that intends to issue transferable shares to have rules that provide for this type of share capital, including its form of transfer, the registration of such shares, and the requirement that the board must give its consent to any proposed transfer of share capital. The FCA also says that it considers any market arrangement that allowed transferable shareholders to make capital gains would normally be inconsistent with registration.

The main problem with transferable shares is the lack of any secondary market or social motive for buying such shares after they have been issued by a society. Buying shares when they are first issued, in a society that needs the capital to get started, provides the investor with a clear social motive. But buying those same shares from an existing shareholder only helps that shareholder get their money back; it does nothing for the society; there is no social motive. Of course, it might be possible for a society to create a financial motive by offering high interest rates on transferable shares, but this might be contrary to the purpose of the society, which is primarily social not financial.

Another problem with transferable shares is that they are not exempt from financial promotions regulations if issued by a co-operative society, which means that this type of society must have their communications vetted by an FCA authorised adviser if they do decide to issue transferable shares. It may also need to comply with the prospectus regulations if the amount of share capital on offer is above the minimum level. The only exception to this is a community benefit society, which is exempt from the prospectus regulations when issuing transferable share capital as long as

the money raised is used for its business purposes. However, a community benefit society offering transferable share capital may be making a direct offer financial promotion, which is subject to Financial Promotion Order 2005 and the FCA's Conduct of Business Sourcebook rules 4.7. Such a society must have its communications supervised by an FCA authorised person (see Section 7.3.3). For these reasons, transferable share capital is outside the remit of the Community Shares Unit.

It is theoretically possible to issue shares that are transferable and withdrawable, but it is assumed that such capital would be subject to the £100,000 individual shareholding limit, and at the same time would not be exempt from financial promotions regulations. That is why this type of share capital is also outside of the remit of the Community Shares Unit.

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## 2.2.4 Non-user investor shares

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Whereas membership and investment is normally open to anyone who supports the purpose of a community benefit society, in a co-operative society the FCA makes a distinction between user and non-user members. It provides the following registration guidance to co-operative societies that intend to raise capital from non-user members:

- "The rules of a society which wants to raise capital from non-user investor members expressly provide for non-user investor shares, and the terms attached to these shares are clearly stated
- The voting rights of non-user investor shareholders are restricted by the rules of the society. The society's rules prevent this category of shareholders voting on a motion to convert the co-operative to a company. Societies can, however, include a power to elect one or more non-user investor share representatives to the board
- Ultimate control of the society remains with members other than non-user investor members at all times. Non-user investor members do not together have voting rights that when combined would result in user-members losing control of the society."

Unlike under European statute, where the collective voting power of investor-members is limited to no more than a quarter of the total, the FCA does not explain what it means by ultimate control. It could be assumed to mean that user members must always be in position to win a vote on a resolution, including a special resolution, which would mean that user members must collectively hold at least 75% of the votes.

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## 2.2.5 Membership shares and subscriptions

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Non-withdrawable, non-transferable shares are referred to as membership shares in this Handbook. (It should be noted that all types of shares in a society confer membership, unless the society adopts rules that specifically exclude such rights from a class of share.) All three types of society can issue this type of share capital. If the shareholder ceases to be a member of the society, the share capital is cancelled and transferred to the general reserves of the society. This type of share capital is normally of fixed and nominal value, typically ranging from £1 to £25, although there is no legal limit on the amount. However, a bona fide co-operative society should not have artificial restrictions to open membership, and a highly priced membership share might be seen as such a restriction.

The rules determining how membership is terminated are important in deciding the price of a membership share. A society can charge a member an annual subscription, and failure to pay this subscription is normally grounds for terminating membership. Where a society charges members an annual subscription, it is normal for the membership share to have a low nominal value, usually deducted from the first year's subscription.

It is reasonable for a membership share to be set at a higher fixed price if the society does not charge an annual subscription, on the grounds that the cost of providing membership services must be covered by the price of the membership share.

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## 2.2.6 Multiple classes of shares

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The FCA has approved model society rules with multiple classes of shares, including shares that carry no membership rights, shares with different membership rights, and shares with different terms and conditions. Each of these variations is dealt with in turn in this sub-section.

It is unusual for a society to issue shares that carry no membership rights, and where this does happen, it is normal to restrict the sale of these shares to members only. The reason for this is usually that the society already has an established membership, based on membership shares and annual subscriptions, and it wants to maintain the pre-eminence of membership shares over this second type of share. However, this type of arrangement might act as a deterrent to new investors, who are unlikely to want to pay an annual subscription in order to maintain their investment.

The FCA has approved model rules for societies with multiple classes of share with different voting rights. If a bona fide co-operative society wants to have multiple classes of shares, it must still uphold the principle of member democracy, although there can be sectional representation on the management committee, and a class of membership can be excluded from voting on sensitive matters.

Multiple classes of shares can also be used to vary the terms and conditions of each class of share. For instance, a society may incentivise investment in a pre-start society by granting early investors preferential terms for withdrawal and/or preferential interest rates. Or a society may decide to establish a new class of share for a specific investment project, with its own withdrawal terms and interest rates, distinct from the terms applying to the original class of shares. Such arrangements place a duty on the society to maintain transparent financial accounting and reporting procedures.

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## 2.2.7 Sweat Equity

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Many new societies are highly reliant on their founder members and volunteers doing unpaid work to help get the enterprise up and running. This is sometimes referred to as sweat equity. If a society decides to issue sweat equity it should do so by paying the person for services rendered, following UK income tax law, and for that person to voluntarily purchase withdrawable share capital on the same terms and conditions as other members. New societies should carefully consider the operating losses this practice will generate, and its potential impact on solvency.

## 2.3 LIQUIDITY OF WITHDRAWABLE SHARES

Withdrawable shares provide investors with an exit route from investment not available to investors in transferable shares. This liquidity is the main reason why the society form is so suitable for a community enterprise with many investors. The best way that liquidity can be achieved for investors with transferable share capital, is for the enterprise to be large enough to be listed on a stock exchange. A stock exchange works when there are sufficient buyers and sellers interested in an enterprise's shares to generate liquidity. Usually, an enterprise needs to have issued between £10m and £25m in share capital before it achieves liquidity on a stock exchange. In smaller enterprises liquidity is usually provided by selling all the shares to another person or enterprise, but such decisions can only easily be taken if ownership of the enterprise is restricted to a handful of shareholders with majority control. Alternatively, some enterprises engage in matched bargain services, whereby a third party service provider, matches buyers and sellers of transferable shares, on behalf of the enterprise.

Withdrawable share capital solves the problem of liquidity for investors, but it does so by creating a responsibility for societies to provide that liquidity. This is a major difference between a society and a company, which has no responsibility to provide liquidity for shareholders unless it has issued redeemable shares.

The FCA's new registration guidance, published in November 2015, says that a society should only allow the withdrawal of shares if "it has trading surpluses that match or exceed the value of shares involved, and the directors believe that the society can afford to pay its debts taking into account all of its liabilities (including whether it will be able to pay its debts at the date of withdrawal, and for a year after that, any contingent or prospective liabilities,) and the society's situation at the date of the transaction".

This is the first time that the FCA has made a public policy statement regarding the withdrawal of share capital. The Co-operative and Community Benefit Societies Act 2014 has little to say about the withdrawal of share capital. However, Section 124 of the Act makes members fully liable for the value of their share capital held up to one year prior to the society being wound up, in the event that the society becomes insolvent, even if the member has withdrawn their share capital and ceased to be a member of the society. This places a duty on directors not to allow the withdrawal of share capital if there are grounds to believe that society may become insolvent. The withdrawal of share capital should be restricted or suspended if the liabilities of the society exceed its assets, or are in danger of becoming so in the next twelve months.

The main indicator that a society may be insolvent is if it has accumulated losses or negative reserves. Any amount of negative reserves means that the society would be unable to pay the full paid-up value of its share capital were the society to cease trading. In such circumstances a society should either suspend withdrawals, or only allow discounted withdrawals if its rules make provision for such an arrangement (see Section 3.2.9). If a society's negative reserves exceed its total share capital then it is insolvent, and it should cease trading, unless the directors have grounds for believing that the society is trading profitably and that it can reduce its accumulated losses.

The FCA requirement that trading surpluses should match or exceed share withdrawals is taken to

mean that a society should not allow withdrawals if the society is, or could become, insolvent, unless the society's rules make provision for restricted withdrawals in such circumstances. This interpretation of FCA policy would mean that withdrawals could also be financed by the inflow of new share capital, the reinvestment of share interest and dividends by members, and by reductions in the capital requirements of a society.

An important distinction needs to be made between solvency and liquidity. The mere fact that a society has cash to pay for withdrawals does not mean that it is solvent, or that withdrawals can be allowed. Equally, a solvent society with accumulated profits may find itself unable to allow withdrawals because it lacks the available cash to do so. A solvent society has a duty to maintain a cash position that allows it to fulfil the terms and conditions of its share capital.

A society can manage its capital liquidity in several ways. It has the powers to set terms and conditions for the withdrawal of share capital in its rules (see Section 3.2.9). This usually includes rules that require members to give a set notice period, from one week to one year, of their request to withdraw some or all of their capital; rules that cap the total amount of share capital that can be withdrawn in any one financial year; and rules that allow the society to discount the value of its share capital. In addition, a society can adopt a rule which gives the management committee the power to suspend withdrawals. This rule is mandatory if the society is to present its share capital as an asset on its balance sheet.

Whichever method of providing for liquidity is used, the society will need to establish cash balances capable of meeting requests for withdrawal. There are five main ways in which a society can provide liquidity for members. All of these methods rely on the society being solvent in the first place. Before issuing community shares, a society should decide which of these methods it will use, and ensure that this is reflected in its business plan and share offer document. This, in turn, will depend on the starting point of the society, its trading activities, objects and purpose. The methods can be used singly or in combination.

- **Raising new share capital:** This can be achieved through an open offer, enabling the society to recruit new members and raise new share capital. Open offers work best where the community is already engaged as customers, volunteers, employees, or suppliers, making the invitation to become a member and investor all the more appealing. Existing members can also be encouraged to invest new additional capital.
- **Reinvestment by existing members:** It is common practice for societies to credit the share accounts of existing members with share interest and/or dividend payments, thereby reinvesting this money in the share capital of the society. Depending on the scale of these payments, this can be a significant source of new capital. The consequent growth in value of a member's share account is the closest a member will get to achieving a capital gain in a society.
- **Redemption from reserves:** A profitable society that is accumulating reserves may use these reserves to finance share withdrawals and reduce its liability for share interest.
- **Reduction in capital requirements:** Some societies, especially those in the community energy sector, plan to reduce their capital requirements over the lifetime of their fixed assets, and to wind up the society at some pre-determined point in the future. In such circumstances, it is reasonable to allow share capital withdrawals in line with the depreciation of the society's fixed assets.
- **Replacement with loan capital:** Solvent societies that have reinvested reserves into business assets and do not have cash to finance withdrawals may decide to borrow capital to provide



liquidity.

Most new societies suspend the withdrawal of share capital for an initial period of up to five years. It can be justified by the society's financial projections and when it anticipates having cumulative retained profit. However, there are drawbacks to suspending withdrawals for long periods, especially if this means that a society is unable to make an open offer and to recruit new members (see Section 4.6).

## 2.4 ASSET LOCK PROVISIONS

An asset lock is a constitutional device that prevents the distribution of residual assets to members. The purpose of an asset lock is to ensure that the public benefit or community benefit of any retained surplus or residual value is cannot be appropriated for private benefit of members. Asset locks are a defining feature of community shares, because they remove the scope for members to make speculative capital gains resulting from the dissolution, disposal or conversion of the society into a company.

Charities (including charitable community benefit societies) and Community Interest Companies have statutory asset locks. Societies can adopt a voluntary asset lock, but only community benefit societies have the option of adopting a statutory asset lock.

The Community Benefit Societies (Restriction on Use of Assets) Regulations 2006, and the equivalent regulations for Northern Ireland, introduced the option for community benefit societies to adopt a statutory asset lock with similar qualities to those available to Community Interest Companies. Community benefit societies adopting this restriction are referred to in the Regulations as 'prescribed community benefit societies'. Any community benefit society, except for those that are charitable community benefit societies or registered social landlords, can be prescribed.

This restriction on the use of assets means that any residual assets, after all members' share capital has been refunded according to the rules of the society, must be transferred to one or more of the following: another prescribed community benefit society, a community interest company, a charity, a charitable community benefit society, a registered social landlord (subject to conditions), or any equivalent body in Northern Ireland or a state outside the United Kingdom.

The restriction can be included in the rules of a new community benefit society, or adopted by an existing community benefit society through a special resolution. Schedule 1 of the Regulations specifies the exact wording of the rules that must be adopted. A community benefit society must have this form of statutory asset lock, or be a charitable community benefit society, in order to qualify for Social Investment Tax Relief (see Section 8.6).

A charitable community benefit society must have an asset lock that satisfies the requirements of charity law. The 2006 Regulations cannot be used for this purpose because they do not restrict the use of residual assets exclusively to charitable purposes only.

The FCA requires all community benefit societies to have rules which prevent the profits or the assets from being distributed to members, be it the statutory asset lock or a voluntary asset lock. It

has additional powers under secondary legislation to enforce a statutory asset lock, which includes the power to issue warning and enforcement notices, and to order restitution by the officers of the society.

Community benefit societies that have chosen not to adopt the restrictions set out in the 2006 Regulations are free to amend their rules regarding the use of assets, subject to FCA approval. A community benefit society might prefer the flexibility of this form of asset lock, because it could in the future amend its rules and apply to become a charitable community benefit society, something which a society with the prescribed asset lock could not do.

The position of co-operative societies is less clear. The FCA does not provide specific guidance on asset locks for co-operative societies. However, it does highlight the importance of the ICA Statement on Co-operative Identity, in determining whether a society is a bona fide co-operative, and the third principle on member economic participation refers to co-operatives having common property and indivisible reserves, although it qualifies this with the use of words such as 'usually' and 'possibly' (see Section 2.1.2). Most co-operative societies adopt a voluntary asset lock in their rules. There is scope to specify that these rules are fundamental to the society by requiring a higher voting threshold to change these rules. There is, however, no legal mechanism to entrench these rules to prevent them from being changed under any circumstance.

The same applies to voluntary asset locks in community benefit societies. Entrenchment of the asset lock rule can only be achieved by adopting a statutory asset lock.

A society can convert into a company, subject to the provisions of Sections 112-113 of the Co-operative and Community Benefit Societies Act 2014, which requires societies wishing to convert into a company to pass a special resolution to that effect, supported by at least a three-quarters majority vote in which at least half the membership has participated (see Section 2.6.4.)

## 2.5 DEBT

### 2.5.1 Borrowing

All societies are required to state in their rules the terms and conditions on which they may borrow capital from members and others, including commercial sources. These terms may include details of the security offered to lenders and the maximum amount that can be borrowed. Society legislation makes an important distinction between loans and deposits: loans are used for the business purposes of the society, whereas deposits can be used for other purposes. However, deposit-taking is a regulated activity and most societies adopt rules which expressly forbid it.

There are no legal restrictions on the terms and conditions of the loan arrangements a society enters into. This is treated as a commercial decision of the society. There is no limit on the amount of money a member, or other person, may lend to a society, other than the maximum amount stated in the society's rules. This means that members who want to invest more than the legal maximum for withdrawable share capital could lend additional capital, on terms agreed with the society. These loans can be secured against specific assets, or subject to a floating charge against all assets, or not secured at all. Both parties are free to agree whatever interest rates and repayment

terms they choose.

Sections 59 to 64 of the Co-operative and Community Benefit Societies Act 2014 make provisions for a society to register a charge against its assets with the FCA. There are separate provisions for England and Wales, for Scotland, and for Northern Ireland. In Scotland it is only possible to register a floating charge against the assets of a society. In England and Wales, it is possible to register fixed and floating charges. In both cases the provisions of the 2014 Act form one part of a complex set of legal rules which decide the effect and priority of the security given to the creditor over the society's assets. Most secured creditors will insist on the registration of their charge with the FCA, so to this extent it is required. Also, registered charges are available for inspection on the FCA Mutuels Register, which will be of interest and reassurance to a society's creditors and has a role in fixing the priority of charges over the society's property.

A society seeking to raise capital through the offer of non-transferable debt instruments, including bonds, loan stock, debentures or any other form of debt instrument, is exempt from financial promotions and prospectus regulations. Transferable debt instruments issued by societies are also exempt from financial promotion regulations, but this only applies to non-real time or solicited real time communications (see Section 7.3.3).

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## 2.5.2 Bonds

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A bond is a form of loan agreement between an individual and an enterprise. Capital is loaned in small denominations, typically between £100 and £500, and evidenced by a bond or agreement that the society promises to pay interest and to repay the capital to the bondholder on a set date. Bonds are usually transferable between third parties. Bonds are widely used by public authorities, credit institutions and companies, but are rarely used by smaller community enterprises. Bonds do not confer ownership or voting rights.

Most societies prefer to issue shares rather than bonds. The reasons for this are fairly straightforward. Debt has to be repaid according to a pre-agreed schedule and normally carries a pre-arranged interest rate. Equity, particularly withdrawable share capital, is not subject to any pre-arranged repayment schedule or interest rates.

There are, of course, situations where bonds are appropriate. As they offer greater security and certainty, bonds may be a more attractive financial proposition for investors. Registered charities cannot issue equity that bears dividends, so bonds may be a good alternative. Other organisations, such as workers' co-operatives, might like the idea of raising capital from their supporters without having to compromise their principles of workers' control. Bonds provide a good solution to this problem because no voting rights are attached to them. Bonds may be attractive to members who have already invested the maximum £100,000 allowable in withdrawable share capital but still wish to invest more, although societies should be cautious about being over-reliant upon members and should normally restrict any member investing more than 10% of the capital raised by a society. It is possible that some investors would prefer bonds with fixed interest rates and redemption periods.

Some larger co-operatives and housing associations have turned to the London Stock Exchange bonds market to raise capital, but as these issues are not targeted at the public, they cannot be

considered a form of community finance.

Bonds do not provide for community engagement. Bondholders are not members, and they have no voting rights in the affairs of the society. There is not the same scope to engage bondholders in the business activities of the society as customers, volunteers or management committee members. Bonds do not give legal title to the enterprise or convey community ownership.

There are other disadvantages to bonds. They must be repaid by a fixed date, which means that profits will have to be made and set aside to fund these repayments. Although it may be possible to replace old bonds with a fresh issue, this means re-incurring the cost of raising capital, with the attendant risk that investors may not want to renew their bonds. Bonds can also be more expensive, especially if they are issued with a high fixed rate of interest that turns out to be more than the cost of commercial debt over the same period.

There are other ways of raising loan capital from the public, including the offer of loan stock or debenture stock: the former is fully at risk, while the latter is usually secured against a specific asset held by the enterprise. Selling any form of debt product to the public is a regulated activity, subject to the Financial Services and Markets Act 2000 and its associated Regulatory Orders, unless there are exemptions. Co-operative and community benefit societies are usually exempt.

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### 2.5.3 Loans and loan-stock

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The FCA's registration guidance includes guidance for societies intending to issue loan-stock or similar forms of debt security. It is concerned that any rights given to the loan-stock holder or other lenders does not undermine the society's compliance with the conditions for registration. There are three main areas of concern.

Firstly, the FCA is concerned that the loan-stock agreement does not confer any constitutional rights to the loan-stock holder or lender which could compromise member control of the society.

Secondly, although the FCA accepts that the rate of interest on any form of loan is a commercial matter, the loan agreement should not be a vehicle for distributing profits. This implies that any form of profit-sharing arrangement would not be acceptable to the FCA.

Finally, the FCA acknowledges that many loan-stock agreements include an arrangement to allow loan-stock to be converted into shares at some later stage. If such arrangements are to be included in an agreement then they must take a form that ensures the society remains compliant with the conditions for registration. This should include provisions to accommodate the legal maximum individual shareholding a member may have in a society, and the arrangements for non-user investor shares highlighted in Section 2.2.4.

## 2.6 CONVERTING LEGAL FORMS

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### 2.6.1 Converting a company into a society

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A company can, by special resolution, convert into a registered society. Additional requirements apply to community interest companies (see Section 2.6.2).

A special resolution is a resolution passed by a majority of at least three-quarters of the voting shares, if it is a company limited by shares, or three-quarters of the voting members, if it is a company limited by guarantee. A copy of this special resolution, signed by the secretary of the company and the chair of the meeting at which the resolution was approved, must accompany the application to convert into a society.

A company can re-register either as a co-operative or a community benefit society, unless the company is a registered charity, in which case it can only convert into a charitable community benefit society, subject to the consent of the charity regulator for the nation in which the charity is located (see Section 2.6.3). The rules of the new society must be signed by the secretary and three members of the company.

If the enterprise is a company limited by shares, then care has to be taken to ensure that the value of withdrawable shares held by any individual member in the new society will not exceed £100,000, the maximum legally permissible (£20,000 in Northern Ireland). If a member of the company holds in excess of £100,000 in paid-up share capital, the excess share capital should be designated as transferable share capital in the society, and there must be provision in the rules for the society to issue this type of share capital. Alternatively, the company may decide to redeem the shares of members whose shareholdings exceed £100,000, providing that it has the reserves to do so, or it might ask members to convert any excess shareholdings into a loan agreement. These agreements would need to be in place before the conversion was made.

If the company is a company limited by guarantee, then provision must be made for the members of the company to become members of the society by purchasing the minimum amount of share capital stated in its rules. This also applies to a company limited by guarantee that is a registered charity, which must first obtain the consent of the charity regulator in the nation where it is located (see Section 2.6.3).

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## 2.6.2 Converting a community interest company into a society

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Section 6A of the Community Interest Company Regulations 2005 allows a community interest company (CIC) to convert into a society, but only in the form of a community benefit society that has a restriction on the use of its assets in accordance with the Community Benefit Societies (Restriction on Use of Assets) Regulations 2006 or the associated regulations in Northern Ireland (see Section 2.4). A CIC cannot convert into a co-operative society.

In order to convert, a special resolution must be passed by a three-quarters majority vote in favour. A copy of this special resolution must be submitted to the Registrar of Companies, who will forward them to the CIC Regulator. The special resolution must be accompanied by a copy of the rules of the new society and a statement by an authorised member of the company confirming that, in their opinion, when the new rules take effect, the company will become a community

benefit society with the required restriction on the use of assets.

The CIC Regulator must decide whether the company is eligible to cease being a CIC. The company is eligible if, under the Companies (Audit, Investigations and Community Enterprise) Act 2004, it is not under investigation by an auditor, director or manager appointed by the CIC regulator; it is not currently subject to civil proceedings instigated by the CIC Regulator; none of its property is held by the Official Property Holder as a trustee for the company; and it is not subject to any petition to be wound up as a company.

The CIC Regulator must give notice of its decision to the company. If the CIC Regulator states that the company is eligible to cease being a CIC, this notice must be sent to the Financial Conduct Authority (FCA), together with a copy of the special resolution to convert, and the rules of the society containing the restriction on the use of assets. Finally, a certificate issued by the FCA confirming that the society has been registered, together with a copy of the decision by the CIC Regulator, must be submitted to the Registrar of Companies for the conversion to take effect.

If the CIC is a company limited by shares, it should adopt the same approach to share capital as any other private limited company by shares (see Section 2.6.1).

It is not possible to directly convert a CIC into a charitable community benefit society, because of the restrictions imposed by the CIC regulations on the type of asset lock that must be adopted by the community benefit society. Instead, a CIC would first have to apply to the relevant charity regulator to convert the CIC into a charitable company, and then apply to the FCA to convert to a charitable community benefit society, again with the consent of the relevant charity regulator.

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### 2.6.3 Converting a registered charity into a charitable community benefit society

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Charitable incorporated organisations (CIOs) and Scottish charitable incorporated organisations (SCIOs) cannot be converted into any other corporate form, although there is provision for CIOs and SCIOs to amalgamate with other CIOs and SCIOs, and for CIOs and SCIOs to be dissolved and their residual assets passed to another registered charity. Also, a CIO or SCIO can be a wholly controlled subsidiary of a corporate entity, including any type of society.

In England and Wales, a registered charity that is also a company limited by guarantee can be converted into a charitable community benefit society, but only with the consent of the Charity Commission. Any other sort of registered charity would need to follow the dissolution procedures in its governing document. This might involve getting consent from the Charity Commission, but not necessarily. If the governing document contains no powers of dissolution, or the charity's property include a permanent endowment then the charity may need the consent of the Charity Commission (see [www.gov.uk/guidance/how-to-close-a-charity](http://www.gov.uk/guidance/how-to-close-a-charity)).

In Scotland for all cases the charity must apply to the Scottish Charity Regulator to change its legal form. (See [www.oscr.org.uk/charities/managing-your-charity/making-changes-to-your-charity](http://www.oscr.org.uk/charities/managing-your-charity/making-changes-to-your-charity)). The same is true in Northern Ireland, where an application to change legal form must be made to

the Charity Commission for Northern Ireland.

Under the Charities Act 2011, all charitable community benefit societies in England and Wales are exempt charities. This Act provides for the reform of exempt charity regulation, including the appointment of principal regulators or the removal of exempt charity status. The Charity Commission for England and Wales says that:

“No firm decision has been made on the future regulation of community benefit societies [and friendly societies] as charities. One possibility is that those which are registered social housing providers may remain exempt whilst others may lose their exemption if no suitable principal regulator can be found.” (Charity Commission CC23 Exempt Charities, September 2013)

Currently, therefore, in England and Wales a registered charitable company converting to a charitable community benefit society with the consent of the Charity Commission to the changes of its articles would automatically become an exempt charity, and would be removed from the Charity Commission’s register. The Charity Commission does not offer any guidance on this matter but will consider applications on a case by case basis. The Charity Commission will not consent if, in its opinion, the conversion would result in a community benefit society that was not charitable. Therefore, by agreeing to the conversion, the Charity Commission is giving its implicit approval to the charitable nature of the new form. It is up to HMRC to decide whether a charitable community benefit society is an exempt charity, but it will generally defer to the Charity Commission in determining whether a legal entity is charitable.

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## 2.6.4 Converting a society into a company

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A co-operative or community benefit society can convert into a company, except for a prescribed community benefit society, which has a rule restricting the use of its assets (see Section 2.4).

A community benefit society with this rule can only convert into a company if its residual assets are transferred to another similarly asset-locked community benefit society, or registered social landlord, community interest company, charity, or equivalent body in Northern Ireland, and would require the prior consent of the appropriate regulator.

Sections 112-3 of the Co-operative and Community Benefit Societies Act 2014 set out the requirements for a special resolution to be passed by members approving conversion. These requirements state that at least half of the qualifying members of the society must vote on the special resolution to convert, either in person, or where the rules allow, by proxy, and at least three-quarters of those members who vote must be in favour of the special resolution for it to be passed. A qualifying member is a member of the society who is entitled to vote under the society’s rules. A second meeting to confirm the special resolution must be held between 14 days and one month after the first meeting. The resolution to confirm must be passed by the majority of those qualifying members who vote, and the meeting must be quorate under the society’s rules.

The wording of the special resolution should indicate whether the society is converting into a company limited by shares or a company limited by guarantee. If the society is converting into a company limited by guarantee, provisions should be made for members to withdraw or cancel any

share capital they hold in the society.

A society cannot be converted into a pre-existing company. Prior to registering the special resolution with the FCA, the society must apply to Companies House to register the company, telling it that the application is being made by a society with the intention of converting into a company. The society should request that the application is not registered until a date for conversion has been agreed by the FCA and Companies House.

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## 2.6.5 Converting a society into a charitable incorporated organisation or a Scottish charitable incorporated organisation

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In England and Wales there are provisions in the Charities Act 2011 to enable a charitable community benefit society to convert into a charitable incorporated organisation (CIO). However, further regulations are needed to complete the legal framework allowing a society to convert into a CIO. Unless and until these regulations are implemented, it is not possible for a society to convert into a CIO. However, it is possible for a society to be the sole corporate trustee of a CIO, which may mitigate the need to convert a society into a CIO.

In Scotland there are also provisions in the Charities and Trustee Investment (Scotland) Act 2005 to enable a charitable community benefit society and a society to convert into a Scottish charitable incorporated organisation (SCIO).

There is no provision to establish a charitable incorporated organisation in Northern Ireland at the present time.

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## 2.6.6 Converting between society forms

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A co-operative society registered before the commencement of the Co-operative and Community Benefit Societies Act 2014 on 1 August 2014, may convert to a community benefit society without having to register a new society, but not vice versa.

From 1 August 2014 onwards societies are registered as co-operative societies or community benefit societies and cannot convert from one form to another. Instead any society wanting to change its society form would need to register a new society and be allowed to transfer its engagements to this new entity. A community benefit society with a prescribed asset lock would not be allowed to transfer its engagements to a co-operative society, and it is unlikely that the FCA would allow a community benefit society without the prescribed asset lock to do so either.

A community benefit society with the prescribed asset lock cannot become a charitable community benefit society because the prescribed asset lock is unsuitable for a charity and cannot be changed (see Section 2.4). A community benefit society with a voluntary asset lock could revise its rules to meet the requirements for a charitable community benefit society.



## 2.7 AMALGAMATIONS AND TRANSFERS OF ENGAGEMENTS

The FCA's registration guidance provides detailed guidance on amalgamations and the transfer of engagements between societies and other legal entities. This guidance is summarised in this section. However, any society embarking on this course of action should follow the FCA's guidance on these matters, and not rely on the summary presented here.

An amalgamation is the merger of one society with another society or company, to form a new legal entity. A transfer of engagements involves the transfer of a society's business to another society, or to a company. Sections 109-13 of the Co-operative and Community Benefit Societies Act 2014 make provision for both of these actions.

Any two or more societies may be amalgamated to form one new society by means of each society passing a special resolution, supported by at least a two-thirds majority of its members at a general meeting, and subsequently confirmed by a simple majority at a second general meeting held between 14 days and one month after the first meeting.

Members of each amalgamating society will become members of the new society and hold shares in that society in place of the shares they held in the separate societies before amalgamation. The property of each society will be vested in the new society without the need for any form of conveyance. The special resolutions must be registered and approved with the FCA. In the case of a transfer of engagements from one society to another society, members of the transferring society will be made members and shareholders of the other society and the transferring society will cease to exist.

In the case of a society amalgamating with or transferring its engagements to a company, the special resolution proposing this change must secure a three-quarters majority in favour, with at least half of all eligible members participating in the vote. The special resolution must make provision for the society's members' share capital and voting rights in the company that emerges from this process. The special resolution must be confirmed by a simple majority vote at a second general meeting held between 14 days and one month after the first meeting. The society will cease to exist when the amalgamation or transfer is completed.

Prescribed community benefit societies and charitable community benefit societies can amalgamate or transfer their engagements to other prescribed community benefit societies and charitable community benefit societies respectively. They can also amalgamate or transfer their engagements to a registered charitable company.

Any society registered before 1 August 2014 that wishes to refer to itself as a specific type of society on its business stationery, must register a new society of this type and transfer its engagements to this new society.

## 2.8 INVESTMENTS IN OTHER LEGAL ENTITIES

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## 2.8.1 Guiding principles

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Section 2 (1) of the Co-operative and Community Benefit Societies Act 2014 requires all societies to be carrying on an “industry, business or trade” which means that a society cannot be registered if its purpose is to raise share capital to invest in other legal entities.

Section 2 (3) of the Act explicitly prevents co-operative societies from carrying on activities with the object of making profits to pay dividends, interest or bonuses to members on the money invested. It also restricts community benefit societies to business which is of benefit to the community.

Section 27 of the Act allows societies to invest funds in other registered societies, building societies, companies or securities issued by a “relevant authority”, meaning certain types of local government body. It makes no provision for investment in partnerships, including limited liability partnerships. The Act also requires societies to state in their rules whether, and if so, by what authority and in what manner, any part of their funds may be invested.

It is permissible for a society to invest some of its general reserves in other legal entities, but it should only do so to further the objects of the society, and in a way that meets the needs of the society to maintain liquidity and solvency. This would include normal treasury practices of keeping cash in deposit accounts and other types of liquid investment.

A distinction should be made between investing the general reserves of a society, and investing capital raised through a public share offer where the purposes of that offer are to invest in another legal entity. In the latter case, a society should ensure that it invests the capital in a way that allows it to have control over the terms and conditions of the share capital it issued. This includes the terms and conditions for withdrawal of share capital.

A society should not raise capital with the specific intention of investing in other legal entities over which it has no overall control, or to act as a collective investment vehicle, unless it is authorised by the FCA to do so.

The guiding principles are:

- Investment by a society in other legal entities should only be made when it furthers the objects and business of the society.
- A society must always act within its own rules on investment.
- Capital should only be raised to further the objects and business activities of a society, and not to invest in other legal entities over which it has no overall control.
- Any capital raised by a society through a public offer should only be invested in other legal entities in a way that fully protects the terms of the public offer.
- A society should not raise share capital with the specific intention of investing that capital in another legal entity over which it does not have overall control.

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## 2.8.2 Wholly-owned and controlled subsidiaries

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A wholly-owned subsidiary is a legal entity over which the parent organisation has sole control. The subsidiary may be structured as a company but not normally as a society. A society cannot be a

wholly-owned subsidiary because a society must normally have a minimum of three members, or two members if both these members are societies.

Ownership and control usually go together, but in exceptional circumstances it is possible to separate these functions if members are prepared to forgo their control rights in favour of some other entity. This could apply to a community benefit society, where the FCA accept that a parent body can be granted control of the society because the parent body can demonstrate that it will conduct the business of the society for the benefit of the community, and there is provision in the rules of the society to deal with problems of entrenchment. If the parent organisation is a co-operative society then its wholly-owned subsidiaries must also be fully committed to co-operative values and principles (see Section 2.1.2).

If the subsidiary is a company limited by shares, all voting shares must be owned by the society, or, if the subsidiary is a company limited by guarantee, the society must have the sole power to appoint and dismiss directors.

If a society is investing general reserves (retained surpluses and/or donations), it can use whatever method of investment it chooses, be it in the form of equity, debt or donation, bearing in mind its own rules, its overall level of reserves, and the potentially different tax treatments of these forms of investment. If a society chooses to invest in the form of transferable equity then it must be willing and able to sell the subsidiary if this is in the best interests of the society.

If a society is investing capital raised through a public offer it should only invest in a subsidiary in a way that enables it to honour the terms of the public offer. If the society has issued withdrawable share capital, then this capital should only be invested in the subsidiary either in the form of a loan or, in exceptional circumstances, as redeemable share capital if the subsidiary is a company limited by shares.

Company law imposes restrictions on redeemable shares, only allowing a company to redeem this type of share capital using distributable profits, or newly issued shares, unless it is a private company that adopts special procedures to protect creditors. This makes redeemable shares an unsuitable instrument for investing withdrawable share capital in a subsidiary, unless there are reasons for believing that the withdrawal terms of the public offer can still be met.

The repayment schedule for the loan must be consistent with the terms and conditions for withdrawal of share capital from the society. For example, if a society is making an open offer (see Section 4.6) and limits the total amount of share capital that can be withdrawn in any one year to 10%, then the capital invested in the subsidiary must be repayable at this 10% rate. If a society is raising capital through a time bound offer, then the forecast business performance of the subsidiary should be used to set the terms of the offer.

Likewise, the interest or dividends payable on any investment must be consistent with any financial returns mentioned in the offer document. At all times, the society must be minded to manage the subsidiary in the best interests of its members, and be prepared to sell the subsidiary if doing so would serve the society's best interests.

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### 2.8.3 Majority-owned ventures

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A majority-owned venture is a legal entity in which a society holds over half of the voting shares, with other persons owning the remainder of voting shares.

If a society owns a controlling majority of the shares, generally taken to be three-quarters of the voting shares, and in the absence of any shareholder agreements that give any special powers to minority shareholders, then for investment purposes, it can be treated in the same way as a wholly-owned subsidiary.

If a society owns a majority of voting shares but does not have full control of the legal entity, then it can still invest in this legal entity, subject to the following safeguards. The objects of the majority-owned venture should be the same as those of the society. The society should only invest capital in the form of loans or redeemable shares regardless of whether this capital is part of its general reserves or has been raised through a public offer. If the capital being invested has been raised through a public offer, then the terms of the investment should mirror the terms of that public offer. The society should have the power to veto any changes to the governing document of the legal entity, or any associated shareholder agreement.

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### 2.8.4 Joint ventures

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A joint venture is taken to mean a legal entity owned by two or more partners on more or less equal terms. Section 2.8.1 explained that there is no provision in the 2014 Act for societies to invest in partnerships, including limited liability partnerships. Instead, the joint venture must be a registered society or a company.

If a society is investing its general reserves in a joint venture, then it should only do so in pursuit of its objects and business. It should only invest in a joint venture where it has influence over the venture that is written into the shareholder agreement, or by holding at least a quarter of any voting rights. The amount invested should not be so large as to adversely affect its own liquidity or solvency, should the joint venture encounter financial difficulties.

A society should not raise capital through a public offer to invest in a joint venture unless it has overall control of the joint venture (in which case it would be more properly described as a majority-owned venture (see Section 2.8.3)).

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### 2.8.5 Minority stakes

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A minority stake is defined as a shareholding in a legal entity which does not provide the investor with sufficient voting rights to protect their interests. This is usually the case where the investor has less than a quarter of the total voting rights.

A society is entitled to invest some of its general reserves in other legal entities, as long as it acts within its rules and the amount invested should not be so large as to adversely affect its own liquidity or solvency, should the legal entity encounter financial difficulties. It should seek to invest

in a way that best serves the business interests of the society, typically in the form of secured loans, bonds or debenture. Shares should only be purchased if the legal entity is listed on a stock market, the shares are redeemable or withdrawable, or there is some other arrangement in place to allow the society to sell its investment.

A society should not raise share capital to acquire minority stakes in other legal entities.

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## 2.8.6 Investing in other societies

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It is acceptable for one society to invest in another society, subject to the above guidance in this section. But care should be taken to avoid cross-investment of withdrawable share capital, where two or more societies invest in each other, which could artificially bolster the balance sheets of all the societies involved in the arrangement.

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## 2.8.7 Transparency of investments

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As a matter of good practice, a society should declare in its annual accounts and report, details of any investments it has made in other legal entities, along with details of any corporate investment it has received.

## 2.9 INSOLVENCY AND DISSOLUTION

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### 2.9.1 Introduction

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It is the duty of the management committee to act if a society becomes insolvent and is unable to discharge its debts when they fall due. If it fails to act and the society continues trading then it could be in danger of wrongful trading, and the management committee members could become personally liable for the debts of the society.

The Co-operative and Community Benefit Societies Act 2014 introduced major changes to how insolvency in a society can be addressed. However, it should be noted that much of what follows only applies to societies registered in England and Wales. Scotland has its own system of receivership and the 2014 Act does not apply to Northern Ireland.

In 2014, new regulations (Statutory Instrument 2014, Number 229) gave societies facing insolvency most of the same options as those already available to companies. A society can enter into voluntary arrangement with creditors based on the company voluntary arrangements (CVA), or enter into administration, both of which are set out in the Insolvency Act 1986. Alternatively, it can enter into an arrangement with creditors based on Part 26 of the Companies Act 2006. These arrangements are not available to societies that are registered social landlords. And unlike companies, societies cannot enter into administrative receivership where the receiver is working for a secured creditor, not the creditors as a whole.

The FCA's registration guidance provides detailed guidance on the arrangements for insolvency

and dissolution of a society. This guidance is summarised in this section. However, any society embarking on this course of action should follow the FCA's guidance on these matters, and not rely on the summary presented here.

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## 2.9.2 An arrangement with creditors

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An arrangement with creditors, also called a scheme of arrangement, is a legally binding arrangement made by a society with its members and creditors to address its insolvency. The process begins with a court order calling meetings of creditors and members to approve proposals to address the insolvency. Options include reducing the liabilities and/or increasing the assets of the society, or by amalgamation, merger or transfer to another solvent legal entity. Each class of creditor (secured, unsecured, etc) and member has to approve the proposals by a three-quarters majority vote in favour, with members voting on a one-person-one-vote basis, and creditors voting by value of the credit they represent. When the three-quarters support of all the classes of creditor and member has been secured, the scheme arrangement is submitted to the court to sanction. The court will check that the FCA is satisfied that the arrangement does not contravene the Co-operative and Community Benefit Societies Act 2014, before it sanctions the scheme and issues a court order that makes the scheme legally binding on all creditors and members. The scheme must also be registered with the FCA.

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## 2.9.3 Voluntary arrangement based on a CVA

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Instead of attempting to come to an arrangement with creditors, a society can opt for a voluntary arrangement based on a company voluntary arrangement (CVA). This involves the appointment of a licensed insolvency practitioner who is responsible for developing the arrangement with creditors, securing their support for this arrangement, and administering its implementation. The CVA must be approved by creditors representing at least 75% of the debt. A CVA does not require member approval because it cannot involve a restructuring, amalgamation or transfer of ownership of the society itself. Instead a CVA usually involves scheduled payments to creditors through the insolvency practitioner until these debts are paid off.

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## 2.9.4 Administration

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Administration involves the appointment of an administrator (a licensed insolvency practitioner) who takes control of the society, displacing the management committee. The purpose of administration is to sell the business as a going concern, or failing that, achieving a better result for creditors than if the society was wound up possibly through some form of voluntary arrangement, or at the very least, realising the assets of the society for distribution to secured creditors. A society can enter into administration either voluntarily or through a court order. The administrator will assess whether the society can continue to trade so that the business can be sold as a going concern. Administrators are responsible for liaising with all creditors, and making a written proposal for the future of the society within eight weeks of appointment. Beyond that it is up to the

administrator to negotiate an agreement with the creditors and reach an outcome satisfactory to all parties.

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## 2.9.5 Winding-up and dissolution

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A society can be wound-up under the Insolvency Act 1986 if it is insolvent, or by way of an Instrument of Dissolution, if it is still solvent. Member share capital is fully at risk, and any share capital belonging to a member will only be realisable after all other creditors of the society have been repaid in full.

If a society is insolvent, it will be wound up under the Insolvency Act 1986, subject to any other administrative procedures (see Section 2.9.4). Members will lose their share capital, but, under normal circumstances, will not be liable to contribute towards the debts of the society. However, under Section 124 Co-operative and Community Benefit Societies Act 2014, members who have withdrawn share capital up to one year before the date of the insolvency remain liable for the debts of the society, up to the value of the share capital they have withdrawn, if the existing members' share capital is insufficient to cover these debts. This places a duty on societies to suspend all withdrawals of share capital if and when it is known to be insolvent.

If a society is solvent and is up to date in making its annual returns, it can apply to the FCA for an instrument of dissolution to terminate its registration as a society. The instrument is a document setting out the assets and liabilities of the society, the number of members of the society and the nature of their interests in the society, all claims by creditors and the provisions to meet these claims, and proposals for the disposal of any residual assets in the manner prescribed by the society's registered rules. A resolution based on the instrument of dissolution must be supported by at least three-quarters of the members at a general meeting of the society. If the society is dormant, it must be approved by a special resolution passed at two general meetings, the first meeting with a two-thirds majority vote, and the second meeting by a simple majority vote, held between 14 days and one month later. An instrument of dissolution must be advertised by the FCA in the London or Edinburgh Gazette, as well as a newspaper which is local to the society, giving the public three months' notice of the society's dissolution and the right of creditors to ask a court to set aside the dissolution. If the society is solvent, and all creditors have been satisfied, then the society should return members' share capital. Any residual assets should then be disposed of according to the rules of the society. A society with residual assets of less than £1,000 can request to cancel its registration. This does not require the consent of members or a special resolution, but can be subject to a legal challenge.

The final step in the dissolution process is for the society to submit a Section 126 certificate to the FCA after the three month notice period has lapsed, certifying that all the property vested in the society has now been transferred to the persons entitled to it.

Charitable community benefit societies registered with the Scottish Charity Regulator will also have to seek their consent before winding up or dissolving. This is required under section 16 of the Charities and Trustee Investment (Scotland) Act 2005 and they must seek consent at least 42 days in advance of the proposed date of dissolution. Further information can be found at [www.oscr.org.uk/media/1589/dissolving-your-charity.pdf](http://www.oscr.org.uk/media/1589/dissolving-your-charity.pdf).

## 3 GOVERNING DOCUMENTS

### 3.1 REGISTRATION PROCESSES

Any organisation seeking to become a co-operative society or a community benefit society in the United Kingdom (UK) must register its rules with the Financial Conduct Authority (FCA). The registration function of the FCA is distinct from its role as the regulator of the financial services industry.

There are several matters to consider in deciding when to register a new society. Early registration can give a new initiative some momentum, provide it with a legal identity, and limit the personal liability of the promoters. It also enables a society to begin the work of community engagement, allowing people to become members of the society. A consideration against early registration is the cost involved. Pre-start groups may simply not have the resources to cover the cost of registration. There is also the danger of adopting rules that will not be fit for the purposes of the society by the time it is ready to trade.

The FCA website has a section devoted to the registration of new societies, which provides all the necessary forms and notes. The application form states that the FCA service standard for societies is to register 90% of valid applications within 15 working days. There is no provision for the management committee members of societies to self-certify that the governing document is compliant with society law, as there is for companies.

Applicants are required to submit a set of rules that must cover 14 matters required by law (see Section 3.2). Rules can cover additional matters as long as they do not conflict with legislation and are acceptable to the FCA. Once approved, a society is obliged to follow its rules, so it is important that it is committed to implementing all the rules it adopts, including those that are supplementary to the rules required by law. Rules can be added, amended or rescinded, but only with the support of a general meeting of members and the permission of the FCA.

The application form also requires applicants to state whether they are registering a co-operative society or a community benefit society, and to provide additional details if they are registering the latter, including whether it will be a charitable community benefit society. An application can be made to register a new society, or to convert an existing company, including a community interest company, into a society, subject to certain conditions. A company that is a registered charity can only convert into a charitable community benefit society, and this must be approved by the relevant national charity regulator. Similarly, a CIC can only convert into a prescribed community benefit society (see Section 2.6.2).

To register a new society, the FCA requires the name, contact details and signature of at least three founder members, including the secretary of the proposed society. Applications to register a charitable community benefit society must provide more extensive details of all the proposed charity trustees so the FCA can check that the persons named have not been disqualified from acting as charity trustees.

The FCA has a duty to examine the rules of all applicant societies. This is reflected in the fees the



FCA charges to register societies. The fees are lower if the applicant society uses the model rules of a sponsoring body (see Section 3.3). Model rules have been pre-approved by the FCA. It charges an additional fee for inspecting amendments to model rules made by applicant societies.

## 3.2 STATUTORY RULES

### 3.2.1 Name

The FCA has the powers to register the name of a society, and to decide whether a proposed name is 'undesirable'. A name should be unique, memorable, reflect the character of the society, and not be offensive. The FCA says that a name should generally include a reference to the business activity, membership, community of benefit and/or the geographic location of the society. Languages other than English and Welsh cannot be used unless a translation is given to the FCA for approval.

The name must not be the same as, or very similar to, that of another existing society, company or charity, unless it is somehow connected or related to this other entity, and has its express permission. The same applies to defunct entities that have traded within the previous 10 years. Exceptions to this principle will only be made if the proposed business activity or the location is very different from that of the defunct entity, or if the defunct entity never actually traded.

The FCA provides guidance on sensitive words in names, which can only be used if there is supporting evidence to justify their use, or the society has obtained the permission of the relevant authority. There are three main categories of sensitive word: words implying the society trades nationally or internationally, words implying an authoritative or representative status, and words implying a specific object or function. Included in the latter category are the words 'charity' and 'co-operative', which the FCA will only allow the appropriate type of society to use in their registered name. For instance, a community benefit society cannot call itself a co-operative in its name. Other words, such as 'company', cannot normally be used by a society, if they give a misleading impression about the legal form of the society.

All societies must include the word 'limited' in its name, unless it is a charitable community benefit society or if its objects are wholly benevolent, in which case it can apply to not use the word in its name. Charitable community benefit societies registered as charities in Scotland must also comply with the requirements of Scottish charity law on 'objectionable names'. These are similar in most respects to the FCA's requirements (see [www.oscr.org.uk/media/1591/changing-your-charity-name.pdf](http://www.oscr.org.uk/media/1591/changing-your-charity-name.pdf)).

A society, like other legal entities, can use a business name that is different to its registered name. However, the principle of sensitive names applies equally to business names as it does to registered names.

### 3.2.2 Objects

Objects describe the purpose of an enterprise and the scope of its operations. Most sponsoring

bodies provide standard objects rules that are broad and flexible enough to enable the enterprise to fully engage in all forms of business or trade. Some sponsoring bodies encourage societies to be more specific about their purpose, in order to protect the vision of the founders, and to prevent a society changing its purpose without the consent of at least three-quarters of its membership.

To register as a co-operative society, it is a legal requirement that the society should be carrying on "*an industry, business or trade*". This excludes co-operatives that are set up just as investment vehicles in order to invest in the activities of other legal entities. This is reinforced by another requirement that "*a society may not be a bona fide co-operative if it carries on business with the object of making profits mainly for paying interest, dividends or bonuses on money invested with or lent to it, or to any other person*".

To register a community benefit society, the objects rules must be consistent with other requirements of the FCA to test whether the society is of benefit to the community (see Sections 2.1.3 and 2.1.4).

The objects of a charitable community benefit society must be exclusively charitable and be of public benefit if it is to be recognised as a charity. In Scotland, applications for charitable status must be made to the Scottish Charity Regulator (see [www.oscr.org.uk/charities/becoming-a-charity](http://www.oscr.org.uk/charities/becoming-a-charity)). In England and Wales, even though a charitable community benefit society cannot register as a charity with the Charity Commission, it must comply with the Charity Commission's guidance on public benefit if it is to be recognised as an exempt charity by HMRC. (See [www.gov.uk/government/collections/charitable-purposes-and-public-benefit](http://www.gov.uk/government/collections/charitable-purposes-and-public-benefit))

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### 3.2.3 Address

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The rules must give the address for the registered office of the named society, which must be in Great Britain or the Channel Islands if registered with the FCA. The FCA must be notified of any subsequent change of address for the registered office.

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### 3.2.4 Admission of members

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The rules must state who can (and cannot) be a member, including individuals, corporate bodies, and the nominees of unincorporated bodies. This includes joint members, where one member must be the nominee representing the interests of the joint members. A society must have a minimum of three founder members, or two founder members if both are societies.

Society legislation has little to say about membership. Section 2 of the Co-operative and Community Benefit Societies Act 2014 requires the registering authority, the FCA, to be satisfied that a co-operative society is a bona fide co-operative, which implies that it must meet internationally agreed principles for membership of co-operatives. No similar requirements apply to community benefit societies.

Legislative changes introduced in 2012 scrapped the minimum age for membership of a society,

and lowered the minimum age for election as a management committee member to 16. However, societies are free to set a minimum age for membership, and many societies have chosen to retain 16 as a minimum age for members. Members under the age of 16 are allowed to hold share capital in a society, but Section 31 of the Co-operative and Community Benefit Societies Act 2014 prevents a person under 16 from issuing a receipt, which means they are unable to withdraw their share capital.

The FCA acknowledges that the question of whether a society is a bona fide co-operative should take into account the International Co-operative Alliance (ICA) Statement on Co-operative Identity. The First Principle of this statement is "*Voluntary and Open Membership: co-operatives are voluntary organisations, open to all persons to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination*".

This has been taken to mean that membership of a co-operative should focus on a user relationship, such as customer, employee or supplier. Most co-operatives focus on a single user group, although some sponsoring bodies offer model rules for multi-stakeholder co-operatives. Being an investor is not normally considered to be a user relationship. The FCA provides registration guidance for co-operative societies that want to provide for non-user investor shareholders. This is covered in more detail in Section 2.2.4.

The concept of a non-user member does not apply to community benefit societies, which are free to admit whoever they choose to membership. Most model rules for community benefit societies define members as those who support the objects of the society.

A society can have more than one category of membership, with different rights attached to these categories. However, co-operative societies must ensure that such membership rules are consistent with the International Co-operative Alliance's Statement on Co-operative Identity.

There is also scope to impose an annual subscription fee as a condition of membership. Annual subscriptions are a useful way of covering the cost of providing membership services and can assist the society in maintaining an up-to-date membership list, by requiring members to stay in touch with the society. However, requiring members to pay an annual subscription can be incompatible with encouraging members to maintain their investment in share capital, unless provisions are made to distinguish between the two types of membership, or subscriptions are waived for members holding more than a specified minimum amount of share capital. Other ways of addressing this issue include rules that allow the society to deduct annual subscriptions from the member's share account, or that convert share capital into debt if membership is terminated as a consequence of failing to pay the annual subscription.

The FCA has also approved model rules that allow for nominee shareholdings. This is where an approved nominee holds shares on behalf of their clients, and exercises their proxy votes at general meetings, subject to restrictions. Nominees will normally be independent financial advisers or the managers of investment funds. While such arrangements may make it possible to attract investment from wider sources, they could weaken the community engagement aspects of community investment, and make the society vulnerable to the influence of the nominee.

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### 3.2.5 Conduct of meetings

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All societies are required by law to hold general meetings of their members on at least an annual basis to oversee the affairs of the society. The rules of a society set out how these meetings should be conducted. Most societies adopt rules that provide for an annual general meeting, where the annual report and accounts are considered, auditors are appointed, management committee members are elected, and decisions are taken on the use of profits and any resolutions to change the rules of the society.

The rules will normally set a quorum for general meetings, usually expressed either as a minimum proportion of the total membership, typically 10%, or as a minimum number of members. Some societies have rules that set the quorum as an either/or option, whichever is the lower. Rules may also be adopted to allow for proxy votes, and postal or electronic ballots.

The rules must describe how votes will be conducted in meetings, and the arrangements for deciding between a simple show of hands or a secret ballot. Nearly all societies work to the principle of one-member-one-vote (there are some secondary and federal co-operative societies with corporate membership rules where there is proportionate voting). There is no provision in society legislation for allocating voting rights to shares. The rules must also set the majority required to amend, rescind or add new rules. The 2014 Act requires special resolutions with specified minimum majorities for decisions to amalgamate with, or transfer engagements to, another society or company (see Section 2.7), or to convert a society into a company (see Section 2.6.4).

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### 3.2.6 Management committee members

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The FCA requires all societies' rules to state how members of the management committee will be appointed and removed, and similarly, how the officers of this committee will be appointed and removed, and the arrangements, if any, for paying committee members. Under society legislation the minimum age for management committee membership is 16.

The good governance of a society depends on having an active management committee, elected by the members, to oversee the affairs of the society. In electing a management committee, members are delegating their sovereign powers to this committee. The management committee members are accountable to the membership, and are responsible for supervising the managers and executive staff who run the business. Societies, except for charitable societies, can choose to have a mix of executive and non-executive members on their management committees, or opt for an exclusively non-executive committee, serviced by executive staff. The management committee members of charitable community benefit societies have a duty to act solely in the interest of the charity and must prevent conflicts of interest from affecting their decisions. This means they cannot receive any payment or benefit without authority, so it is unusual for charities to have executive members of the committee (see [www.gov.uk/payments-to-charity-trustees-what-the-rules-are](http://www.gov.uk/payments-to-charity-trustees-what-the-rules-are) ).

Consideration needs to be given to the size of the management committee, its composition, and

the length of service of committee members. Usually the size of the committee is expressed in terms of a minimum and maximum number of members, typically between three and 12. Some multi-stakeholder societies have rules that reserve a set number of places on the management committee for different membership categories. Societies may also have rules that allow the management committee to co-opt individuals with specialist or professional skills. Most societies require management committee members to either retire or seek re-election after a defined period, typically three years, usually on a rotational basis so that no more than a third of the management committee are standing for election, thus allowing for some continuity of membership.

As a matter of good practice most societies, including charitable community benefit societies, will pay management committee members out-of-pocket expenses. Some societies also pay committee members a fee commensurate with the services they provide. Charitable community benefit societies should follow the guidance provided by their national charity regulator on this matter, and ensure that their rules are compatible with this guidance.

Societies must have rules to remove committee members. Usually this is a power held by a simple majority vote of members at a general meeting. Societies will normally have rules for removing committee members who have been declared bankrupt, or are deemed medically incapable of carrying out their duties. Some societies have rules to remove committee members if they fail to attend a minimum consecutive number of meetings.

The rules must also address the appointment of officers. All societies are obliged by law to appoint a secretary. Other officer posts, such as treasurer, chair and vice-chair, are at the discretion of the society. Other discretionary rules include provisions for the proceedings at management committee meetings, focusing mainly on quora and the role of the chair and the use of electronic media to conduct remote meetings.

The management committee members of a charitable community benefit society are charity trustees by law, and are responsible for fulfilling their personal duties as trustees and ensuring that the society complies with the requirements of charity law. (See Charity Commission CC3: The Essential Trustee.)

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### 3.2.7 Maximum shareholdings

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All societies must have a rule that stipulates the maximum shareholding a member may have. Many societies set their maximum shareholding at the maximum permitted by law for withdrawable share capital, currently £100,000. This maximum does not apply to corporate members that are registered co-operative societies or community benefit societies, where no upper limit applies.

Careful consideration should be given to the proportion of total capital any one individual or corporate entity can invest in a society, in order to limit dependency on larger investors. Societies seeking to raise less than £1m in capital, may choose to set a maximum shareholding limit, below the legal limit, typically 5% to 10% of the total capital required by the society (see also Section

4.5.6). A society may also choose to limit the maximum amount that another society can invest in it, or at least to have special reasons for allowing another society to invest more than 10% of the total capital it requires.

There is no legal maximum limit for transferable share capital issued by a society. For reasons explained in Section 2.2.3, the Community Shares Unit does not advise societies to offer transferable share capital to the general public.

Most societies also adopt rules that set a minimum shareholding for membership. This can vary from a nominal £1 to as much as £1,000 or more. A higher minimum shareholding may be justified if the society does not charge an annual subscription, in order to cover the cost of providing membership services. However, a high minimum shareholding may be a barrier to membership, which could contravene the co-operative principle of open membership, for societies registering as co-operatives. This can be mitigated by establishing mechanisms to allow members to invest in instalments to reach the minimum level.

A society may decide to adopt a higher minimum and/or lower maximum shareholding for a particular share offer than is stated in its rules. This is normal practice for new societies where the targets for an initial share offer might make this a prudent strategy.

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### 3.2.8 Loans and deposits

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A society must have rules stating whether it will allow members or others to hold deposits or make loans to the society and, if so, under what terms and conditions. The rules must also state the maximum amount that can be borrowed.

The distinction between loans and deposits is crucial. Deposit-taking is a regulated activity, whereas accepting loans for the purposes of the business is not regulated. Debt securities are normally exempt from prospectus requirements, and a society is allowed to make non-real-time communications about its own debt securities without complying with the financial promotion rules, which would otherwise require an authorised person to approve the material communicated.

Most societies adopt rules that expressly forbid deposit taking, but allow the society to borrow from members as well as from other sources such as banks, commercial lenders or institutional investors. Some societies have rules that fix the maximum amount that can be borrowed and/or the maximum interest rate that can be paid on loans. Borrowing can be an important way of raising additional capital, especially from members who already have the maximum permitted shareholding.

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### 3.2.9 Terms and conditions for share capital

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Societies can issue shares that are transferable and/or withdrawable, or non-withdrawable and non-transferable (this type of share capital is cancelled on termination of membership, and the money is transferred to the general reserves of the society). The rules must state what type of share capital the society intends to issue, and the terms and conditions applying to these shares.

Very few societies choose to issue transferable shares, for the reasons explained in Section 2.2.3. Withdrawable, non-transferable share capital is the norm for societies, although there are major differences in the terms and conditions adopted by societies for this type of capital, which in turn affect the liquidity of the shares and the capital flows of the society. These terms and conditions also have a bearing on how withdrawable share capital is treated in the accounts of the society.

Most societies adopt rules that give the board the discretion to suspend the right of withdrawal. This rule is necessary for withdrawable share capital to be treated as equity, not debt, on the balance sheet of the society. Shareholders must be told if the board has the right to suspend withdrawals.

The main reason for suspending withdrawals is the time it takes for a new investment to generate sufficient surpluses to finance withdrawals. Societies need to plan for the liquidity of their share capital, and reflect these plans in the terms and conditions of their share offer. Societies planning to apply for Enterprise Investment Scheme (EIS) or Social Investment Tax Relief (SITR) also need to make it clear that withdrawals are at the discretion of the management committee. Beneficiaries of these tax relief schemes must maintain their shareholding for at least the first three years of trading after investment (see Sections 8.4 to 8.6).

However, the main reason why a society may suspend withdrawals is to protect the interests of creditors other than its members. This duty is underlined by Section 124 of the Co-operatives and Community Benefit Societies Act 2014, which states that former members remain liable for any debts incurred by the society before they withdrew their share capital for up to one year after withdrawal, if the society is wound up during this period. It is the duty of the management committee to ensure that such a situation does not arise, by suspending the withdrawal of share capital during any period of anticipated insolvency. This matter is dealt with in greater depth in Section 2.3.

The rules should also state what period of notice a member must give when they ask to withdraw some or all of their share capital. This is usually stated as a minimum period of notice, typically ranging from one week to one year. Some societies also adopt rules that limit the proportion of share capital that can be withdrawn in a year, or that limit withdrawals in some other way, such as linking them to retained profit, or the issue of new share capital.

Another condition sometimes applied to withdrawable share capital is the right of the board to reduce the value of shares. This right is usually linked to an assessment that the net asset value of the enterprise can no longer support the full value of the share capital, justifying a temporary or permanent reduction in share value. Some societies have a rule which allows them to deduct an administrative charge for withdrawals.

The terms and conditions applied to withdrawable share capital have a big impact on the liquidity of share capital and therefore its attractiveness to potential investors. It is very important to ensure that the rules address all the terms and conditions a society may want to place on its share offers.

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### 3.2.10 Audits and auditors

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All societies are required to have a rule stating their obligation to appoint an auditor in accordance with the relevant Act. Societies can, if their rules permit it, pass a resolution at their AGM exempting them from a full professional audit, if their turnover and assets are below a prescribed level (see Section 3.6). Part 7 of the Co-operative and Community Benefit Societies Act 2014 sets out the account, audit and annual returns requirements of societies. Some societies also have additional rules stating their statutory obligation to make annual returns to the FCA.

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### 3.2.11 Terminating membership

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Rules governing the termination of membership have important long-term consequences for societies that promote community investment. The rules should enable a society to manage their membership, ensure that members remain in contact with the society, and provide the scope for dealing with dormant or untraceable members.

Provision must be made for the circumstances under which membership of the society may be terminated, and the arrangements for handling terminations. The rules must allow members to cancel their membership, or for membership to be terminated if the member no longer satisfies the criteria for admission. Most societies also adopt rules that allow the board to expel members, for instance, if a member fails to pay an annual subscription, or fails to respond to communications over a period of two years, or is untraceable by the society.

The rules must also state what provisions have been made to handle claims by the representatives of a deceased member, or by the trustee of a member who has been declared bankrupt.

The rules should also make provision for any withdrawable share capital held by a person whose membership has been terminated. Some societies have rules specifying that nominal amounts of share capital are neither withdrawable nor transferable, but are forfeited if membership is terminated. Other societies have rules that allow withdrawable share capital to be converted into loans upon termination of membership.

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### 3.2.12 Use of profits

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The FCA has different approaches to how profits can be used in a co-operative society and a community benefit society. In addition to this, both the Charity Commission and the Scottish Charity Regulator have agreed a policy about the use of profits by a charitable community benefit society. Interest on share capital is an operating expense for a society and must not be used as a mechanism for distributing profits or surpluses to investors. Section 6 of the Handbook addresses these matters in more detail.

The FCA's registration guidance for co-operative societies draws on the ICA Statement on Co-operative Identity, and the fourth principle on member economic participation, addresses the use of profits in the following way "*Members allocate surpluses in for any or all of the following purposes; developing their co-operative, possibly by setting up reserves, part of which at least*



*would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership."*

The FCA's registration guidance for community benefit societies is much more emphatic: "*any profit made by a community benefit society must be used for the benefit of the community*". This can include the profits being ploughed back into the business, or by being distributed to beneficiaries with objects the same as, or similar to, those of the society.

There are further constraints on how a charitable community benefit society may use profits. Both the Charity Commission and the Scottish Charity Regulator consider that a power to distribute profits is fundamentally incompatible with charity status and have agreed specific policy guidance for charitable community benefit societies with shareholder members, on how these members may be paid interest on their share capital (see Section 6.2).

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### 3.2.13 Official documents

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The FCA requires that the rules state whether the society intends to have a 'common seal', a device for stamping official documents such as share certificates, and if it does have a common seal, to state how it will be used. Most societies make provisions for a common seal or its equivalent.

The law does not require societies to have a common seal, or to issue share certificates, although if a society decides against issuing share certificates it should make alternative provisions so that members know how much share capital they hold.

Societies that intend to pay interest and/or dividends, or that plan to charge members an annual subscription fee, should consider introducing individual share accounts for members. Instead of sending out cheques for interest and/or dividend payments, or share certificates worth the same amount, the society could send members an annual statement of their share account, listing all receipts, withdrawals and charges. This would mean all interest and dividend payments are automatically re-invested, as well as enabling a society to charge an annual subscription fee without having to get members to make an annual payment. In order to manage share accounts this way, a society would need to have a 'lien on shares', which is the right to offset a member's debt against their share capital. The rules would also have to state that any payments to members will be automatically credited to their accounts, unless they already hold the maximum individual shareholding allowed.

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### 3.2.14 Investments

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Section 27 of the Co-operative and Community Benefit Societies Act 2014 allows societies to invest funds in other corporate bodies and local authorities. Societies must have rules making provisions for investment. Some societies have rules determining how investment decisions above a set value must be made. Section 2.8 addresses investment in other legal entities.

### 3.3 SPONSORING BODIES AND MODEL RULES

Sponsoring bodies publish model rules that have been pre-approved by the FCA. The FCA publishes a list of sponsors on its website. Currently, it lists 24 sponsoring bodies, although there are only eight sponsors that produce rules that are suitable for issuing community shares and are marketed as such by the sponsoring body. These bodies are:

- Co-operatives UK
- Development Trusts Association Scotland
- National Community Land Trust Network
- Plunkett Foundation
- Somerset Co-operative Services CIC
- Supporters Direct
- Wessex Community Assets
- Wrigleys Solicitors LLP.

These sponsoring bodies offer a full registration service, which includes offering advice on amendments to their model rules and will submit applications to the FCA on behalf of their clients. Details of their charges are outlined later in this section.

The alternative to using model rules is to employ the services of a legal professional with knowledge and experience of formulating co-operative and community benefit society rules, or to write rules without professional support. The FCA does not require applications to be made by a professional person, although, as noted above, it does charge more for examining applications that are not based on model rules, and these fees are non-refundable, even if the application is rejected.

### 3.4 AMENDING RULES

A society can add, delete or amend its registered rules, subject to the support of a general meeting of its members and FCA approval. The FCA examines applications to register changes to rules to ensure that the proposed changes comply with the relevant legislation, and provides comments on deficient applications. No change to the rules is valid until the FCA has approved and registered the change. A society must follow its own rules for the conduct of meetings (see Section 3.2.5) when seeking the approval of its members for a rule change.

If a society's rules are based on the model rules of a sponsoring body it may be worth contacting the sponsoring body to determine whether any changes have been made to the model rules since the society was registered, or if the sponsoring body has assisted other registered societies to make similar amendments.

Charitable community benefit societies must not amend their rules in a way that would have the effect of it ceasing to be a charity (see Section 197, Charities Act 2011). In Scotland, charitable community benefit societies registered with the Scottish Charity Regulator must notify it when a change is made to their rules, and seek its prior consent where a change to the society's objects is planned. In England and Wales further guidance is available

from [www.gov.uk/guidance/how-to-make-changes-to-your-charitys-governing-document](http://www.gov.uk/guidance/how-to-make-changes-to-your-charitys-governing-document). It should be noted that any amendment to the rules of a charitable community benefit society in England and Wales that benefit the trustees needs the authorisation of the Charity Commission.

Any amendment to the rules of a society that requires existing members to invest in more share capital, or increases members' liabilities, is not binding on a member unless their written consent has been obtained. This would include a rule change that raised the minimum shareholding a member must hold to be a member.

### 3.5 SECONDARY RULES

A society may choose to adopt rules that go beyond the matters required by society legislation. Rules that are not statutory may still be registered with the FCA, or they can be maintained as secondary rules by the society, without the approval of the FCA. Most model rules contain rules that go beyond the statutory matters addressed in Section 4.2. However, any amendments to rules registered with the FCA must be approved by the FCA even if the rule concerned does not address a statutory matter.

Secondary rules, which can also be called regulations, standing orders, or bye-laws, are usually developed to improve the functioning of the society. It is a matter of good practice that copies of secondary rules are made available to all members, and changes to secondary rules should be approved at a general meeting.

### 3.6 OBLIGATIONS OF REGISTRATION

Once registered, a society must keep proper accounts, submit an annual return to the FCA, and let the FCA know of any change relating to its registered office. It must also apply to the FCA to amend any of its rules or to change its name. Amendments are not valid until they are registered and approved by the FCA. Societies are legally obliged to be run strictly in accordance with their registered rules, and to inform the FCA if they no longer wish to be registered.

Registered societies are required to make annual returns to the FCA. There is a standard form that should be completed by the society's secretary and returned to the FCA within seven months of the society's financial year end. The form must be accompanied by a set of accounts.

On 6 April 2018 a new regulatory Order introduced new audit thresholds for societies. If the turnover of the society exceeds £10.2m (or £250,000 if the society has charitable objects), or its assets exceed £5.1m, these accounts must be subjected to a full professional audit. This also applies to any society that is a subsidiary, any society that has subsidiaries, or any society engaged in deposit-taking activities.

Societies with a turnover not exceeding £10.2m, or assets not exceeding £5.1m, can, if their rules permit it, and a resolution has been passed at their AGM, get exemption from a full professional

audit, and instead submit an accountant's report verifying the accounts. Unaudited accounts, verified by the management committee, can be submitted if the turnover does not exceed £90,000. If the society's turnover and assets are below £5,000, and it has fewer than 500 members, then it can resolve to submit a lay audit, verified by someone who is not a management committee member or officer of the society.

Societies must maintain an up-to-date register of members and officers. The members' register must include the member's postal address, electronic address (if provided), shareholding and any other property held in the society, and the date of joining and leaving membership. Members have the right to inspect a duplicate copy of this register, excluding details of the members' shareholding and property in the society. The officers' register must include details of the offices held and the dates they took (and left) office. Unlike with companies, societies are not required to file these registers with their registrar. Societies must also keep records of any nomination of beneficiaries by members, in the event of their death. This detail could be incorporated into the members' register.

Societies also have to pay an annual fee to the FCA, known as a periodic fee. This fee is on a sliding scale; in 2017-18 it ranged from £65 for societies with total assets not exceeding £50,000, up to £48 0 for societies with total assets exceeding £1m.

In Scotland, charitable community benefit societies must comply with the requirements of both the FCA and with the Scottish Charity Regulator's monitoring arrangements, which includes the submission of annual accounts (see [www.oscr.org.uk/charities/managing-your-charity/annual-monitoring](http://www.oscr.org.uk/charities/managing-your-charity/annual-monitoring)). The Scottish Charity Regulator operates a consent and notification regime which charitable community benefit societies should make themselves familiar with. This includes seeking consent to change their name or purposes. (see [www.oscr.org.uk/charities/managing-your-charity/making-changes-to-your-charity](http://www.oscr.org.uk/charities/managing-your-charity/making-changes-to-your-charity))

## 4 OFFER DOCUMENTS

### 4.1 GUIDING PRINCIPLES

An offer document is any form of promotional literature that encourages the public to invest in a society. Even though a society is exempt from regulation when offering non-transferable withdrawable share capital to the public, there is an obligation on the society and its representatives to be truthful and responsible and to honour the terms and conditions set out in the offer document. This obligation is reinforced by the Misrepresentation Act 1967 (see Section 7.4). It is vital that all information provided in documentation, on videos or websites, at public meetings, and in any other communications with potential investors is accurate, is not misleading, and is the result of careful consideration.

The Community Shares Unit has introduced a Community Shares Standard Mark for offer documents that meet its good practice standards. Further details of the Mark are available in Section 7.6.2. All societies making a public offer of community shares are encouraged to apply for the Mark.

This section of the Handbook provides guidance on four different types of share offer document: membership offers, pioneer offers, time-bound offers, and open offers. It also provides guidance on the application forms that accompany an offer document. This classification of offers is based on commercial practice and not on legal definitions.

The guidance in this section applies to the offer of withdrawable and non-transferable share capital by societies. Offering this type of share capital is not a regulated activity and is exempt from financial promotion regulations and prospectus directives. The bases of these exemptions, and other regulatory matters, are addressed in Section 7.

The first step in planning a share offer is to identify which of the four types of offer is most appropriate for the society at that time. This will change as the society develops, and it is helpful to prepare a longer-term strategy for how the society will move from one type of offer to another over time. Some societies may start out with a membership offer to engage the community in the enterprise and demonstrate how much support there is for their objectives. It is usual to follow up a pioneer offer, designed to raise risk capital to get investment-ready, with a time-bound offer, to implement the investment plan. And most time-bound offers are eventually followed by open offers, in order to generate liquidity for existing members and to ensure the sustainability of the society.

An offer document aimed at the general public should explain the reasons why they are being invited to invest in the society, the risks associated with this investment, and the terms and conditions that apply to the offer. It is important to use simple, non-technical language that is engaging to read from beginning to end. Offer documents should be brief, but they should also address the matters identified in the relevant parts of this guidance. More detailed information supporting the offer document should be made available wherever this is indicated in this guidance. Section 4.2 outlines the basic information to be presented in all offer documents, regardless of type. The Community Shares Unit has produced a guide for the general public called

*Investing in Community Shares*, which explains what community shares are, and is free to download and distribute. The Money Advice Service also provides guidance on withdrawable share capital. The Community Shares Standard Mark is a form of public recognition that a community share offer embodies the principles and guidance set out in this Section of the Handbook.

## 4.2 BASIC INFORMATION

The following information should be provided in all offer documents, regardless of the type of offer, the only exception being where this information is not relevant to the offer:

**Capital-at-risk warning:** All community shares offer documents should make it absolutely clear that anyone buying community shares could lose some or all of the money they invest, without the protection of the government's Financial Services Compensation Scheme, and without recourse to the Financial Ombudsman Service. This warning should be prominently positioned in all offer documents and expressed in plain English.

**Share capital:** The nature of share capital should be explained, and the full terms and conditions that apply to shares should be provided. If withdrawable share capital is being offered, applicants need to know that the only way of getting their money back is by selling shares back to the society, that notice has to be given of the intention to withdraw share capital, that management committee members may have the right to refuse requests for withdrawal, and any other restrictions or conditions that have been placed on withdrawal. It should be made clear that shares do not change in value, unless the rules provide for a reduction in share values, in which case the details of such provision should be made clear. If the share capital being offered is non-withdrawable, the scope, if any, for selling or transferring the shares should be explained.

**Asset lock:** The provision of an asset lock within the rules of the society, and the impact this has on the rights of members over the residual assets of the society.

**Democratic rights:** The society convention of one-member-one-vote should be explained, and contrasted with the company convention of one-share-one-vote.

**Investment limits:** The upper and lower individual investment limits should be stated, and the reasons for these limits should be explained.

**Restrictions on financial returns:** The society's rules on financial returns to members, whether as interest on share capital or dividends on transactions should be explained, as should its policy or practices for setting its annual interest and/or dividend rate. Reference should be made to the FCA's policies restricting financial returns and the good practice requirement that such returns should only be paid from current operating profits.

**Eligibility for membership:** The offer document should make it clear who is eligible to become a member of the society and invest in share capital. It should clearly set out any criteria or restrictions expressed in the rules in the society, including minimum age requirements, geographic location, or transactional relationship with the society.

**Governing document:** A copy of the society's rules should always be made available, typically on

the society's website, together with any necessary explanatory notes.

Some societies may also need to include information about the following matters, where these matters are relevant to the offer:

**Money laundering:** Societies issuing withdrawable share capital are exempt from money laundering regulations; there is no legal obligation on societies to carry out identity checks on applicants. However some societies have adopted the Co-operatives UK Code of Practice in this area, to reduce the risk of money laundering. Where this is the case, such practices should be outlined in the offer document (see Section 7.3.6).

**Conflicts of interest:** Conflicts of interest can arise in some share offers, particularly those made by new societies where the founders, management committee members or promoters have a financial interest in the outcome of the offer.

## 4.3 MEMBERSHIP OFFERS

### 4.3.1 Purpose

The primary purpose of a membership offer is to recruit members rather than to raise investment capital. Building up the membership can be an important starting point for many community enterprises, especially those hoping to attract significant amounts of public funding. Members can also contribute significantly to strengthening the business model of the organisation, not only by investing capital but also by contributing to the business as customers, volunteers, supporters, activists, and even suppliers or paid workers.

A membership offer is often appropriate for societies at the pre-start stage that need to raise development finance to test and prove the viability of their business proposal. This development finance will usually take the form of gifts, grants and donations; although some societies may find it easier to raise this finance through a pioneer share offer. Members are more likely to donate than non-members, and although donations should never be a condition of membership, people are more likely to be incentivised to donate to a society if they are members.

### 4.3.2 Structure

Before making a membership offer, it is important to plan how the society's relationship with members will evolve over time. The rules of the society must enable it to make a membership offer without compromising its ability to make other types of share offer in the future. This may mean establishing a distinct class of membership share (see Section 2.2.5) that is neither withdrawable nor transferable. It may require the member to pay an annual subscription. The subscription rate should reflect the cost of providing membership services, and not be used to raise development finance for the society, unless this is explicitly stated in the offer document. Annual subscriptions are an effective way of ensuring that members still support the society and want to be members. Alternatively, the membership rules of the society can include other requirements that ensure only those who express an interest in membership remain as members.

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### 4.3.3 Contents

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Compared with other types of offer document, a membership offer document can be fairly brief, typically no more than 500 words or a single side of A4. The document should focus on explaining the purpose of the society, the benefits of membership, and the benefits it aims to generate for the wider community. It should also provide the basic information highlighted in Section 5.2, bearing in mind the following points:

- The minimum investment required to become a member should be restricted to a nominal amount. Many societies set this as low as £1, although this can be costly for societies because of the expense of servicing members. More typically, the amount ranges from £5 to £25.
- Any requirement to pay an annual subscription to maintain membership should be clearly stated.
- If the shares being offered are non-withdrawable and non-transferable, this should be stated, but it also obviates the need to provide the following basic information: financial risk, withdrawable share capital, and restrictions on financial return.

## 4.4 PIONEER OFFERS

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### 4.4.1 Purpose

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The purpose of a pioneer offer is to raise share capital for a new society that will be spent on getting the enterprise investment-ready. Investing in an enterprise at this early stage is a high-risk activity, and because of this, pioneer offers should only be made if a society is unable to raise the risk capital it needs from grants, gifts or donations.

Developing pre-start initiatives can be expensive, time-consuming and highly risky. Pre-start development costs may include professional fees for legal advice, society registration, financial advice, planning permission, asset valuations, market appraisals, feasibility studies and business plans. The society will be unable to recoup these costs if its plans turn out to be unfeasible, or if the society subsequently fails to attract the investment capital it needs to implement its business plan. If the society is planning to acquire an existing business or property, there is the risk that the society will lose a competitive bid, and will be unable to proceed, even though the proposition is viable and the society is able to raise the necessary capital.

The best way of financing these development costs is through grants, gifts, donations and other voluntary fundraising methods. However, there is a limit to how much money can be raised this way. Supporters may be prepared to provide more development finance if there is a possibility, however remote, that they could get their money back.

A pioneer offer invites the public to invest share capital, which will be spent by the society to get investment-ready. If the society is unsuccessful and ceases to exist, pioneer members could lose most, or all, of their investment. However, if the society's plans succeed, and it becomes a profitable enterprise, then pioneer member may be able to withdraw their capital in accordance with the terms of the pioneer offer, and subject to any renegotiated terms set out in subsequent



offer documents.

Before making a pioneer offer, the venture needs to prepare a development plan that identifies all the costs that will be incurred in becoming investment-ready. Development costs should be kept in scale with estimates of the start-up costs of the venture, and should not normally be more than 5% to 10% of these start-up costs.

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#### 4.4.2 Structure

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Because pioneer investors are asked to take far higher risks than subsequent investors, consideration should be given to establishing a separate class of “pioneer shares” with different terms and conditions, such as a higher rate of financial return, or a preferential right to withdrawal ahead of other classes of share. Introducing more than one class of share can have an impact on the attractiveness of future share issues. This matter is dealt with in greater detail in Section 2.2.6.

The offer document should make it clear that withdrawal of share capital is suspended indefinitely, or until it is superseded by the terms and conditions for the withdrawal of share capital set out in a subsequent offer document.

Pioneer offers can only be made by new societies that have not started trading. There should be a minimum and maximum fundraising target for the offer, based on the development costs alone. If any of the development costs have already been committed, this should be highlighted, together with an explanation of how these costs have been met.

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#### 4.4.3 Contents

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Pioneer offer documents need to address the following matters:

**Capital-at-risk warning:** The offer document should contain a prominent warning that the society has no business plan and will need to raise substantial, additional capital before it can start trading. Any commitment to pay share interest or allow the withdrawal of share capital is wholly dependent on the future profitability of the enterprise, and its ability to recover early stages losses resulting from the development costs outlined in this offer. Investors could lose some or all of the money they invest without recourse to the Financial Services Compensation Scheme or the Financial Ombudsman.

**Purpose of the investment:** A brief description of the proposed new enterprise, its proposed business, industry or trade, the scale of the enterprise, and the estimated amount of start-up capital required. ,

**Development costs, targets and contingencies:** An analysis of the development costs, the minimum and maximum fundraising targets, other sources of development funding available to the society, and the contingency arrangements associated with these targets.

**Tax relief:** Pioneer share offers may be eligible for tax relief under the Seed Enterprise Investment Scheme, the Enterprise Investment Scheme or Social Investment Tax Relief (see Section 8).

However, offering tax relief at this stage may severely constrain the future actions of the society, committing it to engage qualifying business activities and requiring it to commence trading within two years of receiving the eligible investment. The society should seek professional tax advice or advance assurance from HMRC before offering tax relief in a pioneer share offer.

**Terms and conditions:** Details of the type of share capital being offered, and the terms and conditions that apply to this class of share. The indefinite suspension of withdrawal rights should be clearly stated, as should the reliance of this offer on the success of future share offers for there to be any prospect of pioneer members getting a return on their investment.

**Timetable:** The target date for closing the offer, together with a commitment not to spend any of the finance raised by the offer until the minimum targets or contingencies have been met. An estimate of how long it will take to get investment-ready, raise the capital required, and establish the society as a profitable enterprise.

In most cases, pioneer offer documents will be no longer than 1,500 to 2,000 words.

## 4.5 4.5 TIME-BOUND OFFERS

### 4.5.1 Purpose

Time-bound offers are offers that seek to raise a target amount of capital for a specific investment-ready project within a specified timescale. If the offer fails to achieve its minimum targets, or any of its contingencies, then the money is returned to investors and the investment project does not proceed. Time-bound offers are open to anyone who qualifies for membership, and because these documents promote an investment opportunity to the general public, it is crucial that they meet high standards of probity. Section 5 of the Handbook provides guidance on how offers should be promoted.

The commitment to refund applicants if the offer fails to meet its minimum targets means that measures should be taken to protect the monies received from applicants until the offer has been successful. There are several ways this can be achieved, for instance through the use of escrow or suspense accounts held by trusted third parties, or by payment procedures that are held in suspense until the closing date of the offer. At the very least, a society should hold applicants' funds in a separate account established for this purpose.

Because a time-bound offer is connected to a specific investment proposition, it is normal to suspend the withdrawability of share capital until the investment has been made and the society is trading profitably. Typically, this period of suspension may last up to three years.

Time-bound offers are most effective when the purpose of the investment is clear. The community purpose of the investment should be attractive to potential investors, enabling them to engage with this purpose through the simple act of investment. Potential investors will have three immediate concerns: Are they at risk of losing some or all of the money they invest? What are the community

benefits of the investment project? How can they exit from their investment?

If the society is intending to raise some of the capital it requires from institutional investors, it needs to explain how this institutional funding will affect the interests of community shareholders. Section 1.5 of the Handbook examines institutional investment in more detail, and provides guidance on how it should relate to community shares.

Investors will also want to know how the money raised will be used. Will it be spent on tangible assets that could be sold if the society underperforms and gets into financial difficulties? Or will it be used to provide working capital, covering initial losses, with the inherent danger that continued losses will erode the capital of the society?

There will also be longer-term concerns about the financial returns on the investment. However strong the social motivation may be, financial incentives will always assist the overall motivation to invest. But any offer of financial returns has to be plausible, and supported by evidence presented in the business plan.

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## 4.5.2 Business plans

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All time-bound offer documents should be supported by a business plan that makes the case for the investment project. The business plan should normally be freely available to the public via a website and contain sufficient information and evidence for an independent professional assessment of the business case for investing in the society. Business plans should address some or all of the following matters, in proportion to the scale of the investment project:

- **Purpose and objectives:** the purpose and objectives of the society; summary of its origins, history and track record to date
- **The investment project:** capital required and how this capital will be used; valuations, assessments, terms and conditions affecting any major assets to be acquired; planned sources and costs of capital
- **Proposed trading activities:** description of trading activities; manager competencies; staffing plans; market analysis and marketing plans; member engagement in trading activities
- **Financial forecasts:** cashflow forecasts; projected balance sheets and profit and loss accounts covering at least the first three years of the investment project
- **Funding mix:** sources of capital available to the society, including community shares and institutional investment in the form of grants, debt and equity. How the funding mix relates to the fundraising targets and contingencies for the share offer
- **Share offer:** fundraising targets, timetable, contingencies, terms and conditions, and share liquidity provisions; tax relief (if relevant)
- **Risk analysis:** identification of the key risks facing the investment project, and plans for mitigating these risks
- **Governance:** access to the rules of the society; explanatory notes for these rules; details of the management committee composition and competencies
- **Community engagement:** profile of the community targeted by the offer document; community engagement activities to date; evidence of community support; plans for promoting the offer.

The public availability of a supporting business plan means that the time-bound offer document

can concentrate on communicating with unsophisticated investors, who can, if they choose, seek independent financial advice.

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### 4.5.3 Share capital liquidity

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Societies should have a long term plan for providing share capital liquidity, and honouring the terms of withdrawable share capital set out in their rules. Section 2.3 describes five main methods for providing liquidity:

- Raising new share capital through an open offer
- Reinvestment of share interest (and dividends) by existing members
- Redemption of shares from reserves
- Reduction in capital requirements
- Replacement with loan capital.

The business plan should make it clear which of these methods will be used by the society. Some societies have reducing capital requirements, and plan to cease trading when the fixed assets of the society come to the end of their working life; if this is the case then it should be clearly stated in the offer document.

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### 4.5.4 Capital requirements and fundraising targets

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The total amount of capital required from all sources should be clearly stated in the offer document along with an explanation of how this capital will be used, specifying how much will be spent on fixed assets and how much will be used as working capital.

The offer document should explain how the total capital required by the investment project will be raised, distinguishing between different sources and types of capital. Details should be provided of any proposed institutional investment, be it in the form of grants, equity, loans or other forms of debt that the society has already secured or negotiated, focusing on any terms that may have a material effect on community shareholders.

The total share capital required should be expressed as three fundraising targets:

- the **minimum amount** of share capital to be raised, below which the offer will be deemed to have failed, and the investment project will not proceed;
- the **optimum amount** of share capital sought, which will normally be the total amount of capital required by the society for it to proceed with the investment project in full;
- the **maximum amount** of share capital to be accepted, above which some applications will be refused or scaled back, following the terms set out in the offer document.

The offer document should state how any funding gap between the minimum amount and the optimum amount will be filled. For instance, the gap might be filled by scaling back the investment project, or by drawing on institutional investment, normally in the form of debt, or possibly shares. The cost of these other sources of capital should be clearly stated, together with an explanation of how this will affect shareholders. If the society has entered into an agreement with an institutional

investor, which will subordinate the share capital of members, this should be fully explained in the offer document.

If the minimum amount is not raised within the time period of the offer, including any extensions, the offer will be deemed to have failed, and applicants who have transferred funds should be refunded. The offer document should state the terms of the refund, detailing any administrative charge that may be made.

In certain circumstances the minimum fundraising target can be zero. This is restricted to societies that are already trading and have investment plans that can accommodate very little capital being raised. Such circumstances may exist where the capital being raised is to replace debt finance, and there is an agreement in place to allow the society to repay a flexible amount of this debt. Alternatively, the society may have decided to use share capital to increase its working capital, and is in a position to adjust its trading activities to suit the amount raised, however small.

In most cases the optimum amount and the maximum amount will be the same. However, a society may include contingencies in its business plan explaining how additional capital in excess of the optimum amount will be used. Such contingencies may include provisions to replace debt with equity, to bring forward future investment projects, or to improve provisions for capital liquidity. The CSU guidance is that the maximum target should not normally be more than 25% above than the optimum target, otherwise it undermines the credibility of the business plan and the optimum target.

The offer document should explain what will happen if applications exceed the maximum fundraising target. There are several different ways of addressing this matter:

- Share capital can be allocated on a first-come-first-served basis, and the offer closed when the maximum amount has been raised.
- The offer remains open until the closing date and applications can then be accepted or rejected on the basis of geographic proximity to the society.
- The offer remains open until the closing date and then the amount of share capital allocated to individual applicants can be capped or reduced.

Given the uncertainties of any administrative process, it is normal to ignore small differences in the actual amount raised, compared with the minimum and maximum targets. In this context, contingencies should only be invoked if the actual amount raised varies by 1% or more from the target.

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#### 4.5.5 The offer period and timetable

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All time-bound offers should have an opening date, when the offer is launched, and a closing date after which no further investments can be accepted. There are a number of factors to consider when determining the timing of an offer period.

Primary consideration should be given to the requirements of the investment project itself. When will the capital be used for the stated purpose? How certain is it that the investment project will be

able to proceed according to plan? If the society is planning to purchase an existing business, property or asset, there may be external deadlines to be met. Alternatively, the society may be planning a development that requires permissions, approvals or contractual agreements, and it cannot proceed until these are in place. The offer document should include details of the investment project timetable, highlighting any uncertainties that may affect it. If the investment project is unlikely to proceed within twelve months of the share offer being completed, then members should be given the option of withdrawing some or all of their capital.

The timing and length of the offer period should also take into account the impact on potential investors. The length of the offer period has to be sufficiently long for the publicity and marketing campaign to be successful, but not so long that early applicants have their money held in suspense for extended periods. Offer periods vary in length from six weeks to six months, with a norm of three months. People often wait until near the end of the offer period before investing, partly to ensure that their money is not held in suspense for too long, and partly to see how successful the offer is before committing their money. So there is a danger with long offer periods that potential investors do not respond to the initial publicity, delay their decision to invest, and then forget to make a decision before the deadline.

It is important to get the timing right by, for example, avoiding major holiday periods, when people may not be thinking about investment, or may have other calls on their money. During the months preceding and following the HMRC financial year-end in April, many people make decisions about the most tax-efficient use of their savings and investments.

Offer periods can be preceded by promotions, including invitations to register an interest in the offer, make a non-binding investment pledge, or even to pay a deposit towards the investment. Any deposits should be held in an escrow account and be fully-refundable on demand during the offer period.

Most time-bound offers experience a surge of investment at the beginning of the offer period, followed by a lull, and then a final surge in the last few weeks or days of the offer. At the end of the offer period the society should stop actively promoting the offer, although it can continue to accept late applications if the stated maximum amount has not been exceeded. Active promotion would include making the offer document and application form available to enquirers, or continuing to allow online applications.

An extension to the closing date can only be made if the terms of this contingency are outlined in the offer document. Alternatively, an extension can be made if the society contacts all applicants informing them of the extension, and allowing them the option of withdrawing their application.

Offer periods, including extensions, should not exceed twelve months.

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#### 4.5.6 Minimum and maximum shareholdings

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Currently, the maximum amount an individual can invest in the withdrawable share capital of a society is £100,000. A society is free to determine its own maximum amount below this legal limit, as long as this is stated in the offer document, and is consistent with its rules. A society that is

seeking to raise less than £1 million should consider restricting the maximum individual investment to 10% of its total capital requirements. This will reduce the risk of the society being dependent on larger investors, which in turn could create liquidity problems if a larger investor wants to withdraw share capital (see Section 3.2.7). Exceptions can be made for institutional investors, as long as safeguards are in place to protect the interests of other members. This is addressed in greater detail in Section 1.5.

Caution should be exercised if there is a large spread between the minimum and maximum individual shareholdings, to ensure that an applicant does not inadvertently end up with 30% or more of the total share capital. This could result in the applicant becoming a “connected person” and ineligible for tax relief (see Section 8.4). The same problem could arise if there is a large spread between the minimum and maximum fundraising targets (see Section 4.54). The problem can be avoided by ensuring that the maximum permitted individual shareholding is less than 30% of the minimum fundraising target.

It is up to the society to determine what the minimum investment should be. The minimum investment required by time-bound offers in recent years has ranged from £50 to £1,000. A low minimum investment makes investment more affordable to people on low incomes, and will encourage more people to invest because the stakes are lower. This will also increase the level of community engagement, by increasing the proportion of the target community that can afford to invest. Alternatively, setting a high minimum investment threshold may result in more capital being invested by fewer people, thus reducing the administrative cost of servicing the membership.

Higher minimum investment thresholds can be made more affordable by offering people the opportunity to invest by instalments. Investment by instalments could be incentivised by financial intermediaries offering bridging loans to allow the investment activity to proceed as soon as sufficient investors are identified.

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## 4.5.7 Contents

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Offer documents are aimed at unsophisticated investors so they should be written in an accessible and engaging style. It is important to get the balance right between writing a marketing document that clearly communicates the investment proposition, and a non-technical document which nevertheless provides accurate financial and legal information.

The length of a time-bound offer document should reflect the size of the offer. Small offers, of less than £100,000, may typically be shorter than 2,000 words, whereas medium-sized offers of between £100,000 and £500,000 may warrant a document of up to 4,000 words. Offers seeking to raise larger amounts should be commensurate in length, but not so long as to deter applicants from reading them. The use of small print, technical language, unnecessary details, or other devices that discourage applicants from fully reading the document, should be avoided.

There are nine main elements to all time-bound offer documents:

**The purpose of the investment:** This describes the purpose of the enterprise and how it will benefit members and/or the broader community. It should explain how such benefits will be delivered,

distinguishing between internal and external delivery mechanisms (see Section 6.1).

**Business plan:** The document should provide a summary of the projected income, expenditure and profitability of the society for at least three years after investment. A copy of the full business plan with evidence supporting these projections should normally be available to all applicants.

**Capital requirements:** The total capital required for the investment project should be clearly stated, along with a statement of how this capital will be used, distinguishing between expenditure on fixed assets and working capital.

**Fundraising targets:** The total amount of capital required should be stated, along with the minimum amount, target amount and maximum amount of share capital sought. If the targets include capital from other sources, these should be stated, along with details of the cost of this capital. Details should also be given of what will happen if the offer is under- or over-subscribed. Any administrative charges for investments and/or refunds should also be clearly stated.

**The offer period:** The opening and close dates of the offer should be stated, along with any contingency arrangements for extensions to the offer period. The timetable for implementing the investment project should also be outlined, together with an estimate of when the society will start trading.

**Minimum and maximum investments:** The minimum and maximum amount that can be invested by an individual applicant should be stated, along with any provisions for buying shares in instalments.

**Financial returns:** There should be a statement of the society's policies regarding interest on share capital, dividends on transactions (if relevant), together with any forecasts for future interest and dividend rates, if relevant.

**Tax relief:** If the society has obtained advance assurance from HMRC that the offer is eligible for tax relief through the Enterprise Investment Scheme, Seed Enterprise Investment Scheme or Social Investment Tax Relief this should be mentioned. If advance assurance has been applied for, but not obtained prior to the launch of the offer, any reference to tax relief should be qualified, noting that the society may not be eligible. Applicants should also be advised to check their own eligibility for tax relief, as individual circumstances can and do vary. Sections 8.4 to 8.6 provide more information about these tax relief schemes.

**Track record:** The offer document should summarise the track record of the society, its management committee and senior managers (if any). It should also identify any personal interests the management committee members may have in the offer, and explain what actions have been taken to address potential conflicts of interest. If the offer is made by an established society, it should include a summary of the previous three years of trading and its current financial position, along with access to its full annual reports for the same years, including any social performance data (see Section 4.5.9).

**Basic information:** This should include any information listed in Section 4.2 which has not been provided elsewhere in the document, and may include statements on, or access to documents covering:



- Capital-at-risk warning
- Type of share capital being offered
- Democratic rights of members
- Eligibility for membership
- Governing document
- Money laundering
- Conflicts of interest.

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#### 4.5.8 Re-opening time-bound offers

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A society can re-open a time-bound offer, with a new timetable, if the original offer succeeded in raising at least its stated minimum amount, and if the additional capital to be raised will not result in the total share capital exceeding the stated maximum amount. A society may re-open an offer in order to replace debt capital with share capital, or to launch a new phase of development highlighted in the supporting business plan. In such circumstances the same offer document and business plan can be reused, with revisions to the fundraising targets and timetable.

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#### 4.5.9 Offers made by existing societies

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When an existing society seeks to raise additional share capital through a time-bound offer, it should first seek the approval of its existing member-shareholders, especially if the offer will be made to non-members and/or the amount to be raised will mean that the total share capital will exceed the maximum amount targeted by any previous time-bound offer (see Section 4.5.3).

In addition to a business plan, an existing society should ensure that its annual accounts and reports for the previous three years or more are available to the public. Where a society is raising share capital that will be invested in a wholly owned trading subsidiary, the society should publish group or consolidated accounts, showing how capital flows between the different entities. The offer document should contain a link to a summary of the society's financial performance, the financial returns on share capital, and its history of share capital liquidity. The Community Shares Unit has designed a finance summary template that societies can use to communicate this information, as part of the Community Shares Standard Mark.

There are several other matters that all existing societies making a time-bound offer need to address. If the society has previously made a time-bound offer, sufficient time should have elapsed for that investment to have become operational and the trading performance known, before the new offer is made. Under normal circumstances at least one year should elapse between offers. If a new offer is being made to raise additional capital for the same investment project as the previous offer then the reasons for this must be given. This includes reasons such as cost overruns, delays or unforeseen expenses. The offer document should explain how the additional capital will affect the financial prospects of existing members and investors.

If the proposed terms and conditions of the new offer are different from those that apply to existing

members, then either a new class of membership needs to be created if the differences are permanent, or administrative arrangements need to be put in place to manage any temporary differences. Temporary differences may include the suspension of share withdrawal rights and/or the receipt of interest on share capital.

A time-bound offer should not be made by an insolvent society, unless the stated purpose of the offer is to address this insolvency, and the risks associated with the offer are made very clear. In such circumstances a society should seek to raise additional share capital from existing members before inviting applications from new members.

During the offer period measures should be taken to protect the funds of applicants from the current liabilities of the society. This can usually be done by holding the applicants' funds in a third-party escrow account until the offer closes and the fundraising targets are met.

## 4.6 OPEN OFFERS

### 4.6.1 Purpose

Open offers are integral to the capital flow of established societies, enabling people to join or terminate membership, and as members, to invest or withdraw share capital. Open offers should not be made by societies if the management committee has suspended the right to withdraw share capital.

There are two main reasons why a society may make an open offer of membership and investment. The first is to stimulate and support the organic growth of the enterprise through increased membership and investment. The second reason for making an open offer is to provide liquidity for its share capital, with new investment generating the funds to cover withdrawals. This is appropriate where the society has a trading relationship with its members and it is normal to expect a turnover in membership and investment.

Any society making an open offer needs to consider what action it may take if it attracts more share capital than it needs, and the associated problems of over-capitalisation. It should only use share capital to finance its stated business, industry or trade, and not invest it in other activities that are not part of its stated purpose. Societies may need to consider what actions it will take to prevent over-capitalisation. This could include introducing limits to the maximum individual shareholding of members below the statutory maximum.

### 4.6.2 Structure

An open offer is not time limited or linked to a specific investment plan, which means it is not subject to the same information requirements as a time-bound offer. An open offer should normally be restricted to societies that can demonstrate that their share capital is fully withdrawable. Any initial period when withdrawals were suspended should be over, and withdrawal

notice periods should be no longer than six months. If there is a restriction on the proportion of total share capital that can be withdrawn it should not be greater than the anticipated inflow of share capital resulting from the open offer. The rules of many societies have set this restriction at 10% of share capital in any one financial year. A new society, planning to launch an open offer, at the end of an initial period where share withdrawals have been suspended, should prepare a share withdrawal policy statement, especially if it anticipates that it will need to restrict withdrawals.

If a society plans to launch an open offer when the withdrawal of shares is still suspended, then the offer should be restricted to existing members, and not be promoted to the general public. This practice can be justified where a society is, or might become, reliant on expensive external sources of capital, and members are willing to provide a cheaper source of capital

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### 4.6.3 Contents

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An open offer document should explain why the society is recruiting new members and/or encouraging new investment, and how any additional capital raised will be used by the society.

The document should focus on the broader principles guiding investment decisions by the society, rather than provide details of any specific investment plans.

In comparison with a time-bound offer document, an open offer document should focus on the track record of the society rather than predictions about its future. It is, as ever, vital that high standards of accuracy, transparency and care are applied to drafting the document, as the board remain legally liable under contract and civil law. Open offer documents should contain the following information:

**Purpose:** The document should provide a brief description of the aims, objectives and purpose of the society, and its reasons for making an open offer of investment. It should also outline the investment policies of the society.

**Returns on investment:** A summary of the interest paid on share capital and the social impact of the society over at least the last three years.

**Capital position:** A simple description of the capital position of the society, detailing how the level of share capital, reserves and long term debt have changed over the last three years, accompanied by information about how many members have joined and how many have left.

**Supporting documents:** The document should explain how readers can obtain copies of the annual accounts and social reports of the society for at least the previous three years, as well as an up-to-date copy of the society's rules.

**Other basic information:** This should include any relevant information listed in Section 5.2 which has not been provided elsewhere in the open offer document.

Much of the above information is captured in the annual return (AR30) a society must make to the FCA. The Community Shares Unit has designed a finance summary template that societies can use to communicate this information to members and applicants, as part of the Community Shares Standard Mark.

## 4.7 APPLICATION FORMS

All offer documents, of whatever type, should include an application form. Application forms can be very simple, requiring no more than the name and address of the applicant, and the amount of share capital they are purchasing. But most societies will ask for additional information, to provide them with greater legal protection, to improve the membership administration processes, or to gather other personal information about the applicant. Societies should ensure the form is fully compliant with the requirements of the General Data Protection Regulation.

The application form should always be attached to the offer document, to encourage applicants to read the document. This can be reinforced by asking applicants to sign or acknowledge a statement saying they have read the offer document and understood the terms and conditions of the offer.

Some societies use application forms as a marketing tool. For instance, the form might contain a series of tick boxes to encourage applicants to invest more than the minimum amount, or it might invite applicants to nominate a beneficiary in the event of their death, encouraging them to think of the offer as a long-term investment.

A society's rulebook will normally specify who can and cannot become a member of the society. Even though legal restrictions on the minimum age at which a person can join a society have been removed, many societies still have rules setting a minimum age for membership, and if this is the case, the application form should make this clear. Some societies restrict applications to people who live or work in a specific geographical area, or do not allow applications by people who live outside the UK.

Occasionally, societies will receive requests for joint membership and shareholdings. Such applications should be treated as an application from an unincorporated association or partnership, which is responsible for its own affairs. All parties to the joint application must be eligible for membership, and one of the applicants must act as the nominee representing the interests of the joint applicants. Joint applicants are treated as one member with one vote. Some societies have rules that allow for nominee shareholdings, where a nominee administers shareholdings on their clients' behalf, and the clients are individual members of the society, each with their own membership rights (see Section 3.2.4). The application form may also accommodate applicants buying shares as gifts for third parties (see Section 5.9).

Societies should be aware of the potential for offers to be used for money laundering. Withdrawable share capital is exempt from money laundering regulations, so there is no legal obligation on societies to carry out identity checks on applicants (see Section 7.3.6). However, societies planning to make online offers or accept applications from people living outside the UK, may want to put secondary measures in place to check the identity of investors. These can include restrictions on methods of payment, or restricting investment to applicants with a UK bank account. Co-operatives UK has a Code of Best Practice for consumer societies issuing withdrawable share capital that provides guidance on the prevention of money laundering.

Some societies have developed online application and payment systems. Putting aside the set-up costs of establishing these systems, and concerns about online security, societies may find this a very efficient way of administering an offer, although it may exclude some potential investors. It may also affect the geographical spread of applications, with a consequent effect on the identity of the community. These issues are addressed in greater detail in Section 5.6.

## 5.5 PROMOTING OFFERS

### 5.1 INTRODUCTION

The promotion of non-transferable withdrawable share capital in a society is exempt from regulation (see Section 7), but this does not release a society from its responsibilities to apply best practice to its promotional activities. There are a number of considerations to take into account when promoting withdrawable share capital.

An investment in a society is primarily made for mutual, community, or charitable benefit, rather than private financial gain, so it is important that these benefits are prominent in all promotional materials and take precedence over any financial rewards offered to investors. This matter is dealt with in more detail in Section 6. Community share offers are aimed at people with little or no knowledge of equity investment, or the risks associated with such investment. Most potential investors are unlikely to understand complex financial or legal explanations, or have ready access to expert professional advice. This means that all promotions must be simple, transparent and not overly long.

Offer documents should be the centrepiece of any promotional campaign. Section 4 provides guidance on the contents of offer documents and application forms. The promotional campaign and associated application processes should be designed to encourage potential investors to read the offer document before investing. All promotional activities and materials form part of the contract with the investor and member, so it is important that these activities and materials present consistent information about the offer.

The success of a community share offer is strongly influenced by the quality of the promotional campaign. The campaign should engage the intended community and involve them in the affairs of the society, above and beyond the act of investment. People should be seen not just as potential investors, but also as potential customers, suppliers, employees, volunteers, supporters, and most importantly as active members who will participate in the business and ensure its success.

The use of electronic media and communications is central to most promotional campaigns. Any society planning to use this form of communication must understand their obligations under the General Data Protection Regulation and the Privacy and Electronic Communications Regulations. This is particularly important if a society plans to use more than one form of electronic media to promote its community share offer.

A society making a share offer needs to plan how the shares will be sold, including the application process and the method of payment. Online methods, including crowdfunding, are becoming increasingly prevalent, and are subject to distinct forms of regulation. Other matters, such as the purchase of shares by non-UK residents, shares as gifts, and the use of incentives, need to be carefully considered before the share offer is launched.

### 5.2 COMMUNITY ENGAGEMENT

A community share offer should be targeted at a defined community, be it a geographic community, a community of interest, or a combination of the two. The rules of the society should include a definition or description of the community it aims to serve. In an increasingly complex world most people inhabit many different communities and may occupy many different stakeholder roles within those communities.

The benefit of defining the target community is that it should then be possible to estimate the size of the community, describe its demography, select appropriate promotional strategies, and test the viability of the proposed business model.

Capturing the attention, interest and support of people within the defined community requires careful planning and execution in order to build community identity. It means communicating the purpose and activities of the society in a way that relates to people's mutual, community, or public interests. Attracting an audience is the first step in community engagement. There are a wide range of methods for doing this including the use of websites, social media, email and text campaigns, public meetings, events, door-to-door leafleting, public media coverage and, if budgets allow, advertising.

The next step is to recruit supporters from this audience. A supporter is someone who has expressed an interest in the initiative, provided contact details and consented to receive future personal communications. Each method of attracting an audience has its own ways of recruiting supporters; social media is especially good at making it easy for people to express interest in an initiative and to establish contact. Other methods may require more effort from the audience: signing petitions, filling in surveys, responding to emails, registering on websites, and so on. Building up a contact list of known supporters is invaluable for new societies planning a community share offer. It enables direct communication with the people most likely to invest in the offer, and provides the society with intelligence about the scale of its community. However, care must be taken to ensure that these contact lists comply with current legislation on direct marketing (see Section 5.3).

The next step in community engagement is to convert supporters into members. For new societies it is important to decide whether membership will be offered prior to, and separately from, an investment offer. Section 4 describes four different types of community share offer, including a membership offer and a pioneer offer, both of which normally precede a time-bound offer to raise investment capital for a specific initiative.

Community investment is at its most effective when members are more than just investors, but are also engaged as customers, service users, volunteers, employees, activists, experts, advocates, and/or suppliers. Engaging members in multiple ways strengthens the competitive advantage of the business. Members who have invested are more likely to volunteer or to become loyal customers. This can reduce costs and increase turnover. Member-investors, who support the community purpose of the enterprise, may be prepared to accept lower financial returns if the social value of the enterprise is clear. Multiple forms of member engagement also help the longer-term sustainability of the enterprise, by offering many reasons for people to become members and to invest in the enterprise. This can also help to maintain the long term liquidity of withdrawable share capital (see Section 2.3).

## 5.3 DATA PROTECTION, PRIVACY AND ELECTRONIC COMMUNICATIONS

Any society planning a share offer must pay careful attention to the regulations governing data protection, privacy and electronic communications. On 25 May 2018 the General Data Protection Regulation 2016 (GDPR) came into effect, replacing the Data Protection Act 1998, and sits alongside the Privacy and Electronic Communications Regulations 2003 (PECR). Societies that plan to collect and use personal data must be registered with the Information Commissioner's Office (ICO), which is responsible for enforcing these regulations.

The GDPR requires that personal data must be:

- Collected only for specified, explicit and legitimate purposes
- Used lawfully, fairly and in a transparent manner
- Adequate, relevant and limited to what is necessary for the specified purposes
- Kept for no longer than is necessary for the specified purposes
- Accurate and up to date
- Processed in a manner which ensures security and protects against unlawful processing, accidental loss, destruction or damage.

PECR provides rules about direct marketing or advertising by electronic means such as automated phone, email, fax, text and picture messaging. It also has rules about website cookies, traffic data, location data and security breaches.

Societies need to establish the lawful basis on which they are collecting and using personal data. The GDPR sets on six legal grounds for doing so, of which the following three may be particularly relevant to societies making community share offers:

- Compliance with a legal obligation: this covers applications for membership where the society has a legal obligation to maintain registers of members and directors, inform members of general meetings, and participate in elections and special resolutions.
- Performance of a contract with the data subject: a society has a contract with members as shareholders in the society, and matters associated with that shareholding
- Consent: this is where the data subject has given their positive consent for their personal data to be used for a specified purpose. It could be used to cover non-statutory communications with members, such as newsletters, marketing campaigns, members' events and activities. Consent could also be used for gathering and using personal data of supporters who have expressed an interest in a forthcoming share offer, or pledged their support in some other way.

Most community share offers collect personal data on the legal grounds associated with membership and the contractual obligations associated with share capital. If a society intends to use the personal data it collects through the share offer for any other purpose, it must obtain the active consent of the applicant. This could include using personal data for direct marketing, member campaigns and events, or volunteer activities. Consent must be freely given, specific, informed and unambiguous. This means that the person must opt-in to providing their personal data for the given purpose and it must be as easy to withdraw consent as to give consent.

Societies collecting personal data, including via share offer application forms, must issue a privacy notice to applicants, which identifies the society, the legal grounds and purposes for collecting and



using this data, the length of time the data will be stored, the individual's rights over this data and their right of complaint to the ICO. A privacy notice can be included in the share offer document, application form or by reference to a document on the society's website.

Some societies have websites that collect data through the use of cookies, in which case it should prominently display its website privacy policy, explaining what data is being collected, how and why.

GDPR draws a distinction between personal data and sensitive personal data, which is subject to stricter controls. Sensitive personal data includes information such as a person's health, ethnicity, sexual orientation, opinions or beliefs. Financial information, such as a member's shareholding, or bank account details, is not considered to be sensitive personal data.

GDPR also provides special protection for children's personal data, deeming 16 as the minimum age for consent in this context. Any society offering membership to under 16s needs to obtain parental consent for the collection and use of the child's personal data.

Any society working with a digital platform to promote its community share offer needs to understand how its contract with the digital platform is GDPR compliant. The starting point is to determine which party is the data controller. In some cases, the digital platform will start out as the data controller and will only hand over responsibility as data controller to the society when the share offer is complete. In such instances it is important for a society to determine how it intends to use the personal data it will be given, and the lawful basis on which it may use such data. If the intended personal data use requires active consent, then it is important that the digital platform obtains this consent on behalf of the society. In other cases, the society will be the data controller at all times and is employing the digital platform as a third party contractor and data processor. It is important that the society has a written contract in place with the digital platform, which specifies the roles of each party, how personal data can be used, and the responsibilities for keeping the data secure. Digital platforms will usually be able to supply model contracts that are GDPR compliant.

Societies should have procedures in place to detect, report and investigate personal data breaches. GDPR makes it a duty of organisations to report certain types of data breach to the ICO, and in some cases, to individual, where the data breach is likely to result in risks to the rights and freedoms of individuals, including financial loss.

Some organisations may be required to formally designate a data protection officer, but this is unlikely to apply to societies only dealing with matters relating to membership and community shares that does not involve the processing of sensitive personal data, or regular and systematic monitoring, on a large scale.

The ICO is responsible for enforcing the law and regulations and has the power under GDPR to impose fines of up to €20m or 4% of global turnover, whichever is the greater, for serious breaches. Among the more serious breaches is the use of personal contact details for a different purpose from that for which they were obtained, or security breaches, where personal data stolen, lost or transferred to a third party not on a lawful basis. This includes using the membership lists of a community organisation that supports the aims and objects of the society, but where the members have not consented for their details to be used or passed on to other related organisations.

There is no restriction on sending marketing materials to people who have specifically requested such materials. So, if a person completes an on-line form requesting the organisation to send them a newsletter, offer document or some other form of community shares marketing materials, then it is free to do so.

The principle of consent is central to good practice in direct marketing communications. If a person has freely given their prior consent to a specific method of communication on a specific topic or matter, then it is usually lawful and acceptable. Prior consent to specific methods of communication is especially important if the society plans to make phone calls, because this will allow the society to call numbers registered with the Telephone Preference Service without committing a breach of the rules.

The clearest way of obtaining consent is to include an unticked opt-in box on marketing materials, including websites. The use of indirect, third-party consent, where a person has consented to their personal details being passed on to third parties, is not allowed under the privacy regulations for electronic communications in the form of emails, texts or automated calls.

Consent to direct marketing communications does not last forever. In the case of a community shares offer, consent is linked to a particular offer and does not automatically extend to new offers made by the same society at a later date. Direct marketing materials should always include information on how to cancel or unsubscribe from the communications. The burden of proof that consent has been given is borne by the organisation not the individual, so it is important that societies keep records of all consents it obtains.

## 5.4 COMMUNICATION METHODS

### 5.4.1 Advance publicity

Any form of publicity that refers to a society's intention to sell community shares forms part of the contract with the purchaser of those shares. All public communications, at all stages of a promotional campaign, should be consistent with the contents of the share offer document. These communications should not provide supplementary or additional information that changes the material nature of the offer, or implies different terms and conditions.

At the early stages of planning a community share offer, a society should restrict its public communications to more general matters, and avoid giving details that it might later want to alter when it is ready to launch the offer. As plans develop, care needs to be taken to ensure the consistency of communications across all the forms of media used to promote the share offer, including websites, social media, and public meetings, as well as the published share offer documents.

### 5.4.2 News coverage

It is beyond the scope of this handbook to provide detailed guidance on how to manage media campaigns. From a community shares perspective, accurate factual reporting of the details of any

community share offer is vital. Advance publicity should focus on the purpose of the offer, rather than on the offer itself. So, for instance, if the purpose of the offer is to save the last retail outlet in the community, then this should be the news story. Details of the community share offer should only be released when the share offer document is ready for distribution.

Local, regional, and national news coverage is welcome and achievable. Community ownership, community investment and community shares are novel concepts and may attract media interest. Several community share offers have attracted national news coverage, but this did not appear to significantly alter the geographic distribution of investors. Instead, national coverage tends to bolster local support, perhaps by reinforcing the sense of pride and identity within the target community.

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### 5.4.3 Websites

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All but the smallest of societies need to have their own websites in order to communicate with members and prospective members. Electronic communications are far cheaper and easier to administer than paper-based communications, and a website forms the hub of an electronic communication system. A website enables a society to provide members and prospective members with full information about the society at low cost. It also provides a vehicle for people to express an interest in the society and to consent to future communications, enabling the society to build a contact list of supporters (see Section 5.2). To do this, the website needs to elicit contact. Invitations to receive newsletters, email bulletins, or make pledges should comply with the requirements of the Privacy and Electronic Communications Regulations (see Section 5.3), and as a matter of good practice should require people to opt-in to communications for each of the formats the society intends to use in its direct marketing efforts. If the website uses cookies, it should also be compliant with the General Data Protection Regulation on this matter.

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### 5.4.4 Email and text communications

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Email and text communications count as electronic communications for the purposes of the Privacy and Electronic Communications Regulations, and the electronic storage of this personal data is also covered by the General Data Protection Regulation (see Section 5.3). A society should only email or text people who have consented to receive direct marketing materials from the society on the specific matters being addressed via the particular medium concerned. This applies to existing members, prospective members and supporters who have expressed an interest in a community share offer.

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### 5.4.5 Phone calls

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If a society plans to communicate with members, prospective members and supporters via phone calls it should first obtain their consent. But it can make unsolicited calls, as long as any phone lists it uses have been screened for people registered with the Telephone Preference Service (TPS). A society can only call someone registered with TPS if the person has consented to such communications. When making calls a society must always say who is calling, and provide a

contact address or Freephone number if asked.

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### 5.4.6 Doorstep materials

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Unsolicited mail and hand-delivered promotional materials are allowable, although if these deliveries are being made using an electronic database, then the General Data Protection Regulation still applies (see Section 5.3). Door-to-door leafleting, used by many community share offers targeting small target communities, is fully allowable under almost all circumstances, especially when it does not involve the electronic storage of personal data.

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### 5.4.7 Social media

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Social media campaigns to draw attention to community share offers are a well established practice. It is beyond the scope of this handbook to state how the Privacy and Electronic Communications Regulations applies to all the various forms of social media. The main issue here is whether the electronic message is directed at and can be stored by an individual, in which case prior consent may be required. Where the communications are not directed at or designed to be stored by individuals then the Privacy and Electronic Communications Regulations may not apply.

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### 5.4.8 Published documents

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Published share offer documents, including printed media and electronic documents, form part of the contract between the society and its potential and existing members. As soon as such documents are distributed, or placed in the public domain, they should not be altered or changed without communicating these changes to all existing members and applicants. This means that care should be taken to ensure that all the details of the offer document are correct before publication. If any substantive changes are made to an offer document after it has been published, and before the offer is closed, then all applicants and existing members should be contacted to inform them of the changes and to allow applicants the option of cancelling their application.

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### 5.4.9 Public meetings

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Public meetings are an excellent campaign tool for societies seeking to engage communities in their objects, purpose and projects. Care has to be taken at such meetings to ensure that anything that is said about an impending or live community share offer is consistent with the share offer document, the society's rules and its business plan. If these meetings are used to collect personal data from supporters, the guidance in this Section relating to the General Data Protection Regulation and the Privacy and Electronic Communications Regulations must be followed.

## 5.5 SELLING SHARES

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### 5.5.1 Advance selling and pledges

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Advance selling refers to the practice of inviting a person to pay a deposit towards the future purchase of share capital. A pledge is a non-binding statement of intent to buy community shares at some point in the future.

Pledge campaigns can be a useful way of gauging the level of community support ahead of a community share offer. It will provide a society with a contact list of supporters that will be invaluable when the share offer is ready to be launched. But it also runs the risk of failing to attract significant support and undermining confidence in the share offer. Pledges must be non-binding and supporters should not be repeatedly urged to honour their pledge.

Advance selling that asks investors to pay a deposit before the launch of a community share offer is only acceptable in special circumstances. These include circumstances where the society is competing with third parties to purchase a going concern, or proof of support is needed to raise other sources of capital, or there is some other significant reason justifying the use of advance selling. Any money received from supporters should be held in a secure place, such as an escrow account, or by an independent third party who guarantees any money held on deposit (see Section 5.6). The terms and conditions of the investment must be clear and prominent. This should include the right to a refund at any time up to the closing date of the community share offer itself. There should be clear information about when the community share offer will be launched or the factors that will determine the launch date. Investors should be informed of any delays to the launch date and reminded about their right to a refund. When the share offer is launched, investors should be sent the share offer document and invited to complete their investment or accept a refund. Any administrative charge applied to refunds should be reasonable and clearly stated in the advance selling literature.

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### 5.5.2 Paper-based applications

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Section 4.7 provides guidance on what should be in an application form. Most societies require applicants to return an application form that is attached to the end of the offer document. Paper-based applications are administratively burdensome, but may be more secure and less expensive for smaller offers seeking to raise less than £100,000, where the cost of establishing online application and payment systems could be prohibitive.

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### 5.5.3 Online applications

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For community share offers above £100,000 or where the offer is being made by an established society, it may be worth establishing systems that allow people to make online applications and payments. Online payment methods are dealt with in the next sub-section. However, it should never be possible to purchase shares online without first completing an online application form. The contents of an online application form should be the same as for paper-based applications. Access to the application form should be at the end of the share offer document, and applicants should be encouraged to read the document before submitting an application.

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## 5.5.4 Payment methods

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The simplest way of accepting payment is by cheque. Payment by cheque restricts investment to UK residents and minimises the risk of money laundering. Societies that cash cheques before the share offer closes should place the money in an escrow account (see Section 5.6).

Payments using debit or credit cards require the society to establish a dedicated merchant account, and to establish systems that meet the Payment Card Industry Data Security Standards. However, the cost of establishing a merchant account may be prohibitive for smaller societies, or simply not an option for new societies without a financial track record.

Remote transactions (by mail or online) are allowed by most card payment processors, although the risk associated with such transactions is generally perceived to be greater than that of face-to-face transactions. However, the risk of fraud is comparatively low because it is impossible for a purchaser to resell withdrawable shares to anyone other than the society itself.

There are a number of online payment options. Debit and credit card payments can be processed through a dedicated merchant account, although the cost of security arrangements for online payment may be prohibitive for smaller offers.

BACs and Faster Payments allow people with internet banking arrangements to make one-off payments and to transfer money from their account to other bank accounts, quickly and easily. Faster Payments was introduced in 2008 and allows funds to be transferred within 24 hours, whereas BACs transactions take three days to complete. The main problem with these methods of payment is the potential difficulty of identifying the payee because there is no facility for them to provide their contact details. This problem can be addressed by ensuring that the application form has (or generates) a unique reference number so that applications and payments can be matched. The other problem with using these methods of payment is their reliance on the applicant correctly entering the society's bank details when making the payment; any mistake may make it difficult to retrieve the funds.

PayPal is an online payment service that allows organisations and individuals to make and receive online payments without the need to exchange bank account details. Applicants do not have to have a PayPal account to use the system, or to make a complaint to the PayPal Resolution Centre. But its payment protection policy does not extend to property, so does not apply to the purchase of shares. A society selling shares through PayPal will need to establish a PayPal account, which will allow it to generate invoices, and to collect the name and address of the purchaser. There is a flat rate transaction fee, payable by the seller, currently 3.4% of the transaction value plus 20p. PayPal supports international payments in 24 currencies with the payment automatically converted into the recipient's desired currency. There is no scope to block international PayPal payments, so a society needs to make special arrangements to ensure that it complies with its policies on applications by non-UK residents (see Section 5.8).

## 5.6 RECEIVING FUNDS

When a society makes a time-bound community share offer, the transaction to buy and sell shares

is not complete until the share offer is closed and the society can be certain that the offer has achieved its minimum target for issuing shares (see Section 4.5). Until the society issues the shares, any money it has received from investors needs to be protected from the liabilities and contingent liabilities of the society.

There are a number of ways of providing this protection. The safest way is for the society not to receive payment for the shares until it is in a position to issue them. This could be achieved by informing applicants that cheques will not be cashed until the closing date of the offer, and only if the offer has met one or more of its fundraising targets. Or, the society could use some other payment method that allows payment to be postponed to an agreed date. An alternative to this is to establish an escrow account to receive funds. An escrow account is where money is held by an independent and trusted third party. It is normal for organisations offering an escrow service to administer the offer: receiving and processing all payments, and concluding the transactions when the offer is closed. Ideally, the escrow service provider should indemnify the funds it holds from any liabilities, including bank failures. In all cases, applicants should be told when payment will be taken from their account; this will help reduce the incidence of applicants not having sufficient funds to make the payment.

A new society making a share offer should endeavour to keep its liabilities and contingent liabilities to a minimum until it knows that the share offer has been successful. This means not entering into advance agreements on sales or purchasing, or limiting such agreements to levels that can be covered by existing reserves.

## 5.7 CROWDFUNDING

Crowdfunding is an increasingly popular fundraising tool. The FCA has identified five main types of crowdfunding: donation-based, reward-based, loan-based, investment-based, and exempt. Community share offers fall into the last of these categories and are exempt from the need for FCA authorisation or regulation.

Donation-based and reward-based crowdfunding may be attractive fundraising options for a new society, especially one at an early stage of development that needs to raise money to meet pre-start costs. Donation-based crowdfunding can generate risk capital for a society, free from any obligation to provide a financial return to the donor. Reward-based crowdfunding is more onerous in the sense that the recipient of such funds enters into a contract to provide a reward in the form of a product or service. Both these forms of crowdfunding are unregulated activities and do not need FCA authorisation.

Loan-based and investment-based crowdfunding are regulated activities. Loan-based crowdfunding, also known as peer-to-peer lending, is a part of the consumer credit market. Regulatory responsibilities for this market were transferred from the Office of Fair Trading to the FCA on 1 April 2014. The FCA has introduced a disclosure-based regime to regulate loan-based crowdfunding, and ensure that investors have information that is fair, clear, and not misleading, upon which to base their investment decisions.

Investment-based crowdfunding is a regulated activity. All investment-based crowdfunding

platforms require FCA authorisation to carry out regulated activities. In March 2014, the FCA published a review of the regulatory regime for crowdfunding, including investment-based crowdfunding in non-readily realisable securities. Together with new consumer protection rules introduced in 2014, the FCA requires that financial promotions involving such securities are targeted only at high net worth or sophisticated investors, those who take regulated advice, or those who will confirm that they will invest less than 10% of their net assets in these types of security.

Community share offers are exempt from regulation, and crowdfunding platforms promoting community share offers need to reflect the unique characteristics of this form of share offer. A crowdfunding platform can ease the administrative burden of making a community share offer by providing a means for processing investment applications online. For larger community share offers involving hundreds or thousands of applications, this is a significant benefit. But crowdfunding has its drawbacks: it excludes people without access to websites and online payment methods; it may be more difficult to aim the offer at the target community; and it may undermine efforts to engage members in the day-to-day activities of the society.

## 5.8 APPLICATIONS BY NON-UK RESIDENTS

With the advent of the internet and international payment systems such as PayPal, it is possible for any society that promotes a share offer through its website to attract applications from non-UK residents.

Community engagement is central to community share offers. Many societies rely on the active involvement of members, not only as investors but also as customers, volunteers, supporters, employees and suppliers. It may be much harder to maintain the active engagement of members who reside outside the geographic community served by the society. On the other hand, people located anywhere in the world may have strong personal reasons for identifying with the community served by the society.

Unless the rules of a society state otherwise, there is no legal restriction on where a member of a society resides; applications by non-UK residents are allowable. But there may be laws in other countries that restrict or prevent individuals from directly investing in UK registered corporate entities.

The sale of withdrawable share capital in a society is exempt from UK money laundering regulations (see Section 7.3.6). However, a society may still want to satisfy itself that it is not receiving investments that are the proceeds of criminal or terrorist activities by carrying out identity checks on non-UK resident applicants. The identity of UK resident applications is usually secured by the bank, credit or debit card provider.

## 5.9 SHARES AS GIFTS

It is acceptable to promote the sale of shares as gifts to third parties, subject to the active agreement and eligibility of the gift recipient to become a member of the society. The gift recipient



must confirm that they are eligible and agree to become a member before the shares are issued. A deadline should be set for receiving this confirmation, together with a statement made to both the giver and the recipient that if the confirmation is not received by that date, or if the recipient is not eligible or willing to become a member, then the giver will be refunded. As with all refunds, any administrative charges should be clearly stated and be reasonable.

In the case of time-bound share offers, the shares are not normally issued until the closing date of the share offer, and this date can be used as a deadline for receiving confirmation from gift recipients. But if a society decides to extend this deadline beyond the closing date of the offer, then the funds should be held in suspense either until confirmation is received or the deadline has passed. Additionally, the society should make both the giver and the recipient aware of the difference between the closing date and the confirmation deadline, explaining the consequences for the recipient if the offer is over-subscribed prior to them confirming their application for membership.

Eligibility for membership is set out in the rules of a society (see Section 3.2.4). The most common restriction on membership is a minimum age requirement. Even though there is no legal minimum age for membership of a society, many societies have rules stating a minimum age, typically 16 or 18. If the society has a minimum age rule, it must make this clear in its share offer document and in any associated literature relating to shares as gifts.

If a society promotes the sale of shares as a gift for a person below the minimum age for membership, then the following administrative arrangements should be made. The giver must be eligible for membership in their own right, as the purchase of shares will be in their name, and treated as their property, and subject to the same terms and conditions that apply to the whole share offer. The purchaser should nominate the gift recipient as their beneficiary (see Section 5.12). The society should obtain the personal details of the gift recipient. On the day the recipient becomes eligible for membership, the society should write to both the giver and the recipient, asking the giver to consent to the withdrawal of the allocated share capital, and asking for recipient's consent to membership of the society and the re-investment of the share capital. Normally, the recipient's consent should be obtained before the giver's consent is requested, in case the recipient does not wish to accept the gift in the form of shares, in which case it will be up to the giver to determine what will happen to the share capital, subject to the society's terms and conditions for withdrawal.

## 5.10 PURCHASING SHARES BY INSTALMENTS

Some societies, especially those with a high minimum shareholding requirement, may invite applications from people to purchase shares by instalments. There are several matters to be addressed when establishing such arrangements. If the society is making a time-bound offer and any purchase by instalments is likely to extend beyond the closing date of the offer, then it will be necessary to decide how such purchases count towards the fundraising targets, and how the society will meet its cashflow needs.

One solution is for the society to borrow additional capital from a third party, to be repaid by the instalment purchases. Another solution is to treat instalment purchases as an additional investment,

so they do not count towards the minimum target but do count towards the maximum target, and thus are limited to the range between the minimum and maximum fundraising target (see Section 4.5.4).

Making arrangements so that applicants can borrow money to pay for shares is not considered to be good practice, unless the liability is borne by someone other than the applicants.

A society offering shares by instalments also needs to decide at what point the person acquires membership rights. Normally this will not be until the minimum shareholding has been purchased. Arrangements also have to be made to address the possibility that a purchaser might fail to maintain or complete all the instalments. A society would be within its rights to refuse membership and to deduct administrative charges from any refund, as long as these terms are clearly stated on the application form.

## 5.11 INCENTIVES

The use of incentives to promote the purchase of community shares is acceptable as long as the incentives are consistent with the rules of the society. A community benefit society should not provide personal benefits to members, so any rewards or incentives to purchase shares should not have a resale value. A society using a rewards-based crowdfunding site to promote its share offer should not offer rewards that could be considered a pre-payment for the goods or services of the society.

This does not exclude a society from offering its products or services as rewards in return for donations, in the form of a pre-payment. But, if a society decides to do this, it should ensure that such pre-payments are properly accounted for in its business plan and subjected to the same tax treatment as any other form of trading income.

A society might decide to offer its goods or services in lieu of share interest and/or dividends. This is acceptable, but such payments may be subject to income tax (see Section 8.3) and members should be told how to declare this income to HMRC.

A society might also choose to incentivise membership by offering members' discounts on products and services, or other forms of special offers. This is acceptable, if such incentives are not associated with either how much share capital the member has invested, or their level of transactions with the society. These types of incentive should be regarded as a marketing and promotion cost, or as part of the pricing strategy of the society.

## 5.12 NOMINATION OF BENEFICIARIES

Some societies choose to include a section in their share application form that encourages the applicant to nominate one or more beneficiaries of their shares in the event of the nominator's death. This may be seen as a promotional tactic to encourage applicants to think of share capital as a long-term investment for the benefit of future generations.

The Co-operative and Community Benefit Societies Act 2014 Sections 37-40 requires societies to maintain a record of members' nominations of who will inherit their property in the society in the event of their death. These nomination rights extend to all forms of property in the society, including loans, deposits and shares. Nomination rights only apply to the first £5,000 of a member's property; any amount above this has to be resolved with reference to the deceased person's probate. Section 40 allows a society to distribute property up to £5,000 amongst such persons as are entitled to receive it, without any nomination under Section 37, or letters of administration or probate. However, a society may decide not to rely on Section 40, and require a letter of administration or probate as firm evidence of entitlement in all instances. If the beneficiary is already a member of the society, the maximum individual shareholding rule still applies and if it is exceeded any excess should either be paid in cash or converted into a loan.

## 6 SHARE INTEREST AND THE USE OF PROFIT OR SURPLUS

### 6.1 GUIDING PRINCIPLES

Profitability is central to the long-term financial sustainability of all enterprises. It enables enterprises to build free reserves, finance the cost of capital, provide returns to shareholders, and support beneficiaries. Sustained losses will erode shareholder capital and eventually threaten the survival of the enterprise as a going concern.

The purpose and use of profit in a society is very different from that of a private or public limited company. In a private enterprise the purpose is to maximise the wealth of shareholders by generating profits and capital gains. This is not the case for societies. Section 2(3) of the Co-operative and Community Benefit Societies Act 2014 states that a *“co-operative society does not include a society that carries on, or intends to carry on, business with the object of making profits mainly for the payment of interest, dividends or bonuses on money invested or deposited with, or lent to, the society or any other person.”* Section 2(2)(ii) defines the purpose of a community benefit society as *“being, or is intended to be, conducted for the benefit of the community”*.

The payment of interest on share capital held in a society is regarded as a discretionary operating expense, and not as a distribution of profit. A society should exercise caution in how it determines share interest rates, setting it at the lowest rate sufficient to attract the capital it requires, and making it clear to members that this rate will only be paid if it is affordable to the society.

Charitable community benefit societies are not-for-private-profit organisations, subject also to charity law, and have a different approach to the application of surpluses. This is set out in the Statement of Recommended Practice (SORP), jointly produced by the charity Commission and the Scottish Charity Regulator, which provides recommendations on the accounting and reporting standards that apply to charities. Surplus income over expenditure is regarded as a future resource for charitable activities, which should not be distributed for other purposes. Interest paid to shareholders in a charitable community benefit society is an allowable expense, subject to the provisions described in Section 6.5.

Section 14(12) of the Co-operative and Community Benefit Societies Act 2014 requires all societies to have rules stating *“the way in which the society’s profits are to be applied”* (see Section 3.2.12). Co-operative societies model rules usually include the powers to pay members a dividend drawn from profits, in proportion to the members’ transactions with the co-operative; an option not available to community benefit societies. All societies usually have rules that allow the society to invest some of the profit in the development of the society, and to use some for the benefit of the broader community.

Community benefit societies and charitable community benefit societies must use their surpluses to pursue community benefits or charitable objects. This can be achieved by reinvesting in the society, spending surpluses on charitable or community benefit activities (internal delivery), or donating surpluses to other community organisations or charities with the same or similar objects (external delivery).

Examples of internal delivery include where a community energy society, engaged in the trade of electricity generation, decides to employ a person to provide energy saving advice to the local community. Such expenditure is a legitimate operating expense for the society, if it is in pursuit of its objects, and should be offset against trading surpluses.

Where a society uses external delivery mechanisms for community or charitable benefit, it should endeavour to do so in a tax efficient way, ensuring that donations are gift aided wherever possible.

As a matter of good practice, a society should annually report to members how much of its trading surplus is being used for community or charitable benefit through internal and external delivery mechanisms.

Societies should also make provisions for the future withdrawal of share capital, by using surpluses to build cash reserves (see Section 2.3). These reserves should be sufficient to honour the terms of withdrawal stated in the rules of the society (see Section 3.2.9).

The Co-operative and Community Benefit Societies Act 2014 does not address the circumstances under which interest can be paid on share capital. However, the FCA would not normally regard the payment of interest on share capital as a profit distribution. UK accounting standards and HMRC also treat the interest payable on non-transferable, withdrawable share capital as a pre-profit business operating expense. Interest paid on share capital in a society is a deductible business expense before any liability to corporation tax.

The following sub-sections provide further guidance on how each of the three main types of society should use and distribute profits, preceded by a sub-section on the general principles applying to interest paid on share capital.

## 6.2 INTEREST ON SHARE CAPITAL

All three types of society are allowed to pay interest on members' share capital. This sub-section applies only to co-operative and community benefit societies. Interest on share capital in charitable community benefit societies is subject to separate guidance produced by the Charity Commission and The Scottish Charity Regulator (see Section 6.5).

The FCA's new registration guidance, published in November 2015, places two requirements on societies: *the maximum rate of interest paid on shares is declared in advance of the period for which it is intended to be paid, whether in its rules or elsewhere* and *the declared maximum rate of interest is the lowest rate sufficient to obtain the necessary funds from members who are committed to furthering the society's objects*.

The Co-operative and Community Benefit Societies Act 2014 does not require societies to state a maximum interest rate on share capital in their rules. However, most of the model rules suitable for community share offers do state a maximum rate. Typically, this is expressed as "2% above bank base rates", with some model rules adding, "or 5%, whichever is the greater". One set of model rules says share interest rates "will not exceed the highest rate for fixed term business lending published by the Co-operative Bank".

Some model rules do not address the matter of share interest rates. If a society does not declare a maximum rate in its rules, the FCA expects it to declare a maximum rate elsewhere, presumably in its share offer documents, well in advance of any share interest being paid.

The FCA offers no guidance on how a society might determine the lowest rate of share interest that will be sufficient to obtain the necessary funds, or how the FCA will determine whether a society has breached this guidance. This suggests that the FCA considers this to be a matter particular to the circumstances of each society. This is supported by historical evidence, which shows there is a wide range in the share interest rate policies of societies. In 2015 the CSU analysed 192 share offer documents, published between 2009 and 2014. It showed a wide range of share interest rate policies, from societies that declared they would never pay interest on share capital (14% of the sample), through to societies that were aspiring to pay share interest rates in excess of 7.5% per annum (10% of the sample), including a small number of societies that were aspiring to pay in excess of 10% share interest per annum.

Faced with the difficulties of proving what the lowest rate of interest would be for a share offer, the only reliable alternative is for a society to compare its share offer rates with the commercial borrowing rates for the same investment proposition. If members and applicants are prepared to accept a rate the same as, or below, the commercial rate, this would prove that members are committed to furthering the objects of the society ahead of their own financial interests. This is reinforced by the fact that member shareholders have far less security than a commercial lender. Many societies do make contingent funding arrangements when planning a share offer, in case the offer fails to meet its targets. So the alternative commercial cost of capital will be known to most societies, and could be used as a basis for establishing the maximum share interest rate.

Interest on share capital should never be treated as a profit distribution. Instead, share interest should be treated as a discretionary operating expense, payable only if the society can afford to do so, having taken into account the other liabilities of the society, and the need for reinvestment in the society. The FCA makes it clear that a society should not pay an interest rate above the declared maximum rate, even if the society has made above expected profits, or has paid below the maximum rate in previous years.

Taken together, the FCA guidance is that a society should declare a maximum rate of share interest, in its rules and/or in its share offer document. It should only commit to paying up to this maximum share interest rate when the financial position of the society is known, and that it is satisfied that it can afford to pay the proposed rate without creating liabilities for other creditors, taking into account the society's terms and conditions for the withdrawal of share capital, and the other uses of profit proposed by the society. As a matter of good practice, the management committee should propose a share interest rate for the financial year under consideration at the Annual General Meeting of the society, especially if the rate proposed is less than the declared maximum rate of share interest. The reasons for proposing this lower rate should be set alongside proposals for the use of profit (see Section 3.2.12). In the case of co-operative societies, one of the proposed uses of profit may be to pay members a dividend based on their transactions with the society, a matter covered in the next section.

Apart from interest rates, there are a number of other matters to consider when determining a society's policies on interest payments. Many societies credit interest payments to members' share

accounts rather than sending out interest payment cheques. This increases the amount of share capital in the society, and improves capital liquidity if the money is not tied up in fixed assets.

Interest on share capital is normally paid gross of personal income tax. It is the responsibility of members to inform HMRC of any interest on share capital paid to them or credited to their share account. This should be borne in mind by societies when devising schemes to allow members the option of waiving interest on share capital or donating it to a good cause. Even though the member does not receive the interest, they may still be liable for income tax on that payment.

A society with more than one class of share may pay different rates of interest, if doing so serves the aims of the society. For example, a society may issue a new class of share capital to finance a wholly-owned subsidiary, with all the risk borne by this new capital. In order to attract this capital, it may be necessary to offer a different interest rate from that applicable to other shares in the society.

Some societies may be financed by members' loans in addition to members' share capital. In such cases it is usual for a society to reflect the differences in exposure to risk by setting a lower rate of interest on the loan capital than the share capital. Even if the loans are unsecured and exposed to the same risks as share capital, a society should not pay a higher rate of interest on loans than on shares. The only exception would be if the society had grounds for believing that it would be unable to attract additional capital unless it offered a higher rate of interest on loan capital.

### 6.3 DISTRIBUTIONS IN CO-OPERATIVE SOCIETIES

The term profit is rarely used by co-operatives because it does not sit easily with co-operative values and principles. Instead, the term surplus is used by the International Co-operative Alliance's (ICA) Statement on the Co-operative Identity, Values and Principles, which states how surpluses should be used:

*"Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership."*

This suggests that co-operative societies should only distribute current surpluses, or at least have a policy limiting the distribution of historical reserves.

Surpluses can be distributed to members in proportion to their transactions with the co-operative. This is usually referred to as a dividend or rebate. Only a co-operative society is allowed to distribute surpluses this way, a community benefit society cannot distribute profits in the form of a dividend on member transactions.

The rules of a society describe who can be a member, and the basis of the member's transactional relationship with the society, for instance, purchases by customer members, sales by supplier members and wages of employee members. The amount of share capital held by a member of a co-operative society has no bearing on the dividend they might receive. Instead, dividends are

normally proportionate to a member's level of transactions with the society.

This principle enables co-operative societies to exercise financial prudence in their transactions with members. It can also be an important source of competitive advantage, encouraging member loyalty and rewarding member participation. Members transact at price levels which improve the likelihood that their co-operative will make a surplus. If and when this surplus is achieved, some of it can be returned to members in proportion to their transactions. Thus, the surplus paid by members is rebated to them in the form of a dividend. Members of a consumer co-operative may accept paying higher prices in the knowledge that some of the surplus generated is returned to them in the form of a dividend.

A co-operative society is free to set dividends at whatever rate it deems reasonable, bearing in mind the guidance provided by the ICA Statement on the Co-operative Identity. The FCA offers no guidance on this matter, and society legislation imposes no limits. The management committee of a co-operative society has a duty to determine a rate that will further the objects of the society. In most cases, the management committee will recommend a dividend rate for approval at an annual general meeting of members.

If a society's rules allow it, dividends can be paid into the member's share account, which will bolster the share capital held by the society. Dividends are treated as a pre-profit expense and are deductible for corporation tax purposes. The income tax treatment of co-operative dividend income is dealt with in Section 8.3.

In contrast to dividends, interest on share capital has a lesser role in co-operative societies. The ICA Statement on the Co-operative Identity, Values and Principles, says *"members usually receive limited compensation, if any, on capital subscribed as a condition of membership."* This could be taken to mean that it only applies to the minimum investment requirement, not the actual amount of share capital held by a member.

A co-operative society that trades exclusively with its members, and distributes surpluses only to members in the form of dividends, may qualify for mutual trading status and be exempt from paying Corporation Tax on its profit (see Section 8.10.2).

## 6.4 USE OF PROFIT IN COMMUNITY BENEFIT SOCIETIES

All the profits of a community benefit society must be used to benefit the community. This is usually achieved by retaining and reinvesting profit in the business activities of the society. Societies may also provide community benefits through non-business activities. This can be achieved using internal and/or external delivery mechanisms.

Internal delivery is where a society commits part of its trading surpluses to community benefit activities that are consistent with the objects of the society. This has the effect of reducing the net profit of the society. A society adopting this approach should therefore state in its annual accounts what proportion of revenue expenditure was devoted to non-trading community benefit activities.

External delivery is where the society donates profit to other organisations with the same or similar



objects. Most societies will endeavour to do this in a tax efficient manner, so may choose to donate to charitable organisations.

Paying interest on share capital is an operating expense, not a profit distribution. However, a community benefit society can increase its profits by reducing the amount it spends on share interest. So, as a matter of good practice a community benefit society should make recommendations regarding share interest rates, and the use of profits, to members at an annual general meeting, following the presentation of the annual report and accounts. These accounts should state the net profits of the society, and propose what proportion of this profit should be reinvested in the society, used for the benefit of the community, or donated to other organisations with similar community objects.

As part of its annual report the society should explain how the proposed reinvestment, or use of funds, will benefit the community. The same applies to any proposed donations to other organisations. The annual report might use social accounting techniques, or other methods that help members understand how the society benefits the community.

## 6.5 INTEREST AND PROFIT IN CHARITABLE COMMUNITY BENEFIT SOCIETIES

In common with all charities, a charitable community benefit society must devote its resources to the pursuit of its charitable objects. Surplus income should either be re-invested in the society or used to support its charitable objects in some other way. In this context, the payment of interest on share capital is seen as an operating cost, and not a distribution of surplus.

The Charity Commission and The Scottish Charity Regulator have agreed the following policy in respect of the payment of interest on share capital by societies that are registered charities with the Scottish Charity Regulator or are recognised as exempt charities by HMRC.

*“The regulator’s position is that a power of a community benefit society to pay interest on shares is not incompatible with charitable status, provided that the following features are required by the society’s rules:*

- 1. The interest rate is set at a level which is not in itself a motivation to buy shares and which the charity trustees can justify as being in the interests of the charity by reference to available commercial rates for borrowing.*
- 2. The cost is part of the society’s revenue expenses and met before the surplus is determined.*
- 3. The rates are declared in advance of the period for which they will become payable, just as for a bank or building society account, and never retrospectively.*
- 4. There is a power to suspend interest payments in the interests of the society.*
- 5. There is a power of the society to withhold repayment of the shares, either temporarily or indefinitely and to write the value down below the nominal £1.*
- 6. The shareholding does not confer any rights to the underlying assets of the society.*

*7. In the event of a solvent dissolution, shareholders cannot be paid more than the nominal value of their shares."*

This statement relates to the rules of the society, and determines the maximum rate of interest payable on share capital. The management committee usually has the discretionary powers to pay less than this maximum amount.

## 7 REGULATION AND GUIDANCE

### 7.1 INTRODUCTION

The offer of community shares, or more specifically withdrawable, non-transferable shares in a society, is not a regulated activity and falls outside the scope of the Financial Services and Markets Act 2000. The Community Shares Unit develops and promotes standards of good practice for community share offers as part of its commitment to voluntary self-regulation. This section of the Handbook sets out the regulatory context within which this guidance and voluntary regulation can be developed.

The Financial Services and Markets Act 2000 provides the legal and regulatory framework governing the financial services industry in the UK. The Financial Conduct Authority's objectives are to protect consumers, enhance the integrity of the financial services sector, and promote effective competition. Consumer protection is vital for public confidence in savings accounts and deposits. Investment products, where the risks and potential rewards are greater, need to conform to common standards in order to ensure effective competition and to help the public understand what they are purchasing.

Without good regulation there is a danger that the public could lose confidence in banking and financial services, which would have a major impact on the economy. The Financial Conduct Authority (FCA) says that good financial regulation is based on eight key principles: efficiency and economy; proportionality; sustainable growth; consumer responsibility; senior management responsibility; recognising the differences in the businesses carried on by different regulated persons; openness and disclosure; and transparency.

Community share offers are not regulated by the FCA. This lack of formal regulation could undermine public confidence in community shares and raise concerns that some societies might behave in an irresponsible manner. Three things stand in the way of this happening. The FCA, as the registrar of mutual societies, has the powers to de-register a society if it believes it is not complying with society legislation. These powers are summarised in Section 7.5. Any offer or inducement to invest in community shares is subject to contract law. This is explained in Section 7.4. The Community Shares Unit has undertaken to promote voluntary self-regulation among societies making community share offers. It has introduced a Community Shares Standard Mark for community share offers and licenses practitioners who can award this Mark to offers that meet the standards. These provisions are outlined in Section 7.6. Together, these measures should provide the conditions for voluntary self-regulation, and for good practice to prevail.

Section 7.3 explains how community shares relate to the Financial Services and Markets Act 2000 and the rules that regulate financial promotions in the UK. Financial promotions are communications that encourage people to engage in investment activities. It is not intended to be a comprehensive guide to the legislation, and practitioners are advised to seek expert legal opinion if they are devising financial promotions that may test the boundaries of this guidance.

Voluntary regulation places a responsibility on societies to be open and transparent about their activities. Section 7.2 sets out the legal duties to disclose information about the membership and

financial performance of a society, and provides guidance on how the principles of openness and transparency can be extended to the fundraising activities of a society.

## 7.2 OPENNESS AND TRANSPARENCY

Section 89 of the Co-operative and Community Benefit Societies Act 2014 obliges a society to submit an annual return to the FCA within seven months of its financial year end. The annual return consists of a balance sheet and revenue account for the society, plus the auditor's report (or equivalent) and the FCA's annual return form AR30. Section 90 of the 2014 Act requires societies to make this annual return available to all members and anyone else who requests it. There is provision within the Act for this duty to be discharged by publishing the latest copy of the annual return on the society's website.

Sections 103 and 104 of the 2014 Act requires a society to make its register of members available for inspection to members and anyone else with an interest in this document. This does not include the right to see details of a member's share account or other financial relationships with the society, unless the member has given their written consent to this disclosure.

The Community Shares Unit recommends that all societies in receipt of community investment should normally make, as a matter of good practice, the following information available on the society's website:

- Copies of its annual accounts for at least the previous three years (if applicable) accompanied by the auditor's report or equivalent
- Copies of the annual return to the FCA(AR30) for the at least the previous three years, or an up-to-date completed copy of the finance summary template produced by the Community Shares Unit for share offers awarded the Community Shares Standard Mark
- An up-to-date list of the officers of the society and its management committee members, including details of how to contact them
- An up-to-date copy of the society's rules
- A copy of any community share offer document published in the previous five years
- A copy of any business plan published in conjunction with an offer document in the previous five years
- A copy of any current registered charges over the society's assets.

A charitable community benefit society registered with the Scottish Charity Regulator must also comply with its reporting arrangements including the statutory requirement to provide a copy of their annual accounts. Furthermore, Section 23 of the Charities and Trustee Investment (Scotland) Act 2005 states that the charity must provide a copy of its constitution and accounts to a person who requests a copy.

## 7.3 FINANCIAL SERVICES AND MARKETS ACT 2000

### 7.3.1 Background

The Financial Services and Markets Act 2000 (FSMA) and related legislation, provides the legal and regulatory framework for the financial services sector in the UK. The Act created the Financial Services Authority as the regulator for insurance, banking and investment business. This body was succeeded by the FCA which focuses on regulating the consumer financial services sector in the UK, with other powers transferred to the Prudential Regulation Authority and the Bank of England. The FCA is also the registrar of mutual societies; a responsibility which is unrelated to its duties as a regulator.

Among many other things, FSMA sets out the legal and regulatory requirements covering a range of activities, including the offer of securities, such as shares and bonds. There are three main requirements to be aware of: what constitutes a regulated activity, and therefore falls within the scope of FSMA; the restrictions on financial promotions, that is, how investment opportunities are promoted or communicated to the general public; and the requirements to publish an FCA-approved prospectus. FSMA also sets out a range of exemptions and exclusions from these requirements, some of which apply to co-operative and community benefit societies issuing community shares.

Exemption from the prospectus requirements does not imply exemption from the financial promotion requirements. So, for instance, a community benefit society issuing transferable share capital is exempt from the prospectus requirements but not from the financial promotions requirements. These matters are explained in more detail below.

### 7.3.2 Regulated activities

Section 19 of FSMA sets out a general prohibition on any person carrying on, or purporting to carry on, a regulated activity. Section 22 of FSMA defines what types of financial services are regulated activities by reference to the FSMA (Regulated Activities) Order 2001. Article 76 of this Order states that transferable shares in a society are a specified investment and the offer of this type of share capital falls within the scope of regulated activities. But other forms of shares in societies, such as non-transferable withdrawable shares are not included.

Article 18 of the Order also excludes from regulation a company making arrangements to issue its own shares, or any person issuing debentures. Even though these are not regulated activities, the offer of such shares or debentures may still be subject to financial promotion regulations. Section 755 of the Companies Act 2006 prohibits the public offer of securities in a private company.

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### 7.3.3 Financial promotions

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Section 21 of FSMA sets out restrictions on how financial promotions can be made. Essentially, the contents of any form of communication encouraging the public to make an investment must be approved by an FCA authorised person. This applies to all financial services activities except those that are not regulated activities.

FSMA (Financial Promotion) Order 2005 Article 35 makes it clear that the financial promotion restrictions do not apply to any communication by a co-operative or community benefit society relating to any form of debt instrument, such as debentures, loan stock and bonds, including transferable debt instruments, where communications are restricted to non-real time or solicited real time communications. But these restrictions do apply to transferable shares in a society, and any form of deposit taking, both of which are controlled investments (see Schedule 1 paragraphs 14 and 15). Non-transferable, withdrawable shares are outside the definition of a controlled investment for the purpose of the financial promotion rules, so the restrictions do not apply to this type of share capital.

In any case, FSMA (Financial Promotion) Order 2005 Article 62 states that the financial promotion restrictions do not apply to the sale of the body corporate. It defines this as the sale of 50% or more of the voting shares in a corporate body, and given that under most circumstances a community share offer will result in a more than 50% increase in the number of voting members of a society, then the financial promotion restrictions do not apply.

The Financial Promotion Order also exempts communications with a wide range of people such as certified high net worth individuals, self-certified sophisticated investors, and the “common interest group” of a company. These exemptions may be significant for social enterprises making financial promotions that are not co-operatives or community benefit societies. Communications made by third parties, including “mere conduits”, communications by journalists, and generic communications are also exempt. A mere conduit is someone who communicates materials wholly devised and provided by others.

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### 7.3.4 Prospectus requirements

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Section 85 of FSMA requires organisations making a financial promotion to publish an FCA-approved prospectus if they are offering transferable securities. The prospectus requirements do not apply to non-transferable securities, such as withdrawable share capital in societies. There are also exemptions for the following:

- Transferable securities issued by charities
- Transferable securities issued by community benefit societies, if the money raised is used solely for the purposes of the issuer’s objectives
- Transferable securities offered by non-profit making associations or bodies similar to charities and community benefit societies, which could be taken to mean any organisation with a statutorily defined asset lock, such as a Community Interest Company
- Offers of transferable securities where the offer is being made only to qualified investors, or to fewer than 150 people, or where the total being sought is less than the sterling equivalent of

€2,500,000.

Community benefit societies are only exempt from regulation when making public offers of transferable shares if the "*proceeds of the offer will be used for the purposes of the issuer's objectives*" (see Schedule 11A, FSMA). This is taken to mean the objects of the society, as stated in its rules. However, transferable shares do not fit the definition of community shares (see Section 1.2.2). Section 2.2.3 explains why transferable shares are considered to be outside of the remit of the Community Shares Unit.

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### 7.3.5 Deposit taking

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Section 4 of the Co-operative and Community Benefit Societies Act 2014 states: "*a society which has any withdrawable share capital may not be registered with the object of carrying on the business of banking.*" Section 67 of the same Act restates this prohibition but also creates an exception for small amounts of less than £400.

This means that any society that does issue withdrawable share capital must ensure that it does not engage in the business of banking. This is reinforced by Section 2(1) of the Co-operatives and Community Benefit Societies Act 2014 which requires registered societies to be carrying on a "*business, industry or trade*". It can meet this requirement by ensuring that its withdrawable share capital is only used to finance its own trading activities, and not to fund the trading activities of other entities. This does not mean that a co-operative or community benefit society cannot invest in another legal entity under any circumstances. Section 2.8 of the Handbook sets out the basis on which a society can invest in another legal entity.

Defining what is meant by the business of banking and deposit-taking is difficult. Raising share capital solely in order to invest in other legal entities, or to make personal loans to members, could be interpreted as the business of banking, and should generally be avoided by co-operative and community benefit societies.

Building societies and credit unions are subject to their own legislation and regulations and are outside the scope of this Handbook.

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### 7.3.6 Money laundering

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FSMA gives powers to the FCA to make rules that aim to prevent and detect money laundering in connection with the carrying on of regulated activities by authorised persons. This does not apply to a society issuing withdrawable shares because it is not a regulated activity.

The Money Laundering Regulations 2007 do not apply to societies when they issue withdrawable share capital (see Regulation 4). This removes the burden of having to carry out identity checks on applicants and having to follow other procedures laid down by these regulations. Nevertheless, simple measures such as only accepting payment for community shares via a UK-based bank account or equivalent, are considered good practice.

Consumer societies that are members of Co-operatives UK have agreed to a Code of Best Practice on Withdrawable Share Capital, which requires them to establish the identity of any person investing more than £500 by requiring two separate forms of identification, one proving who the person is, and the other proving where they live.

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### 7.3.7 Consumer protection

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FSMA established the Financial Services Compensation Scheme (Part 15) and the Ombudsman Scheme (Part 16), in order to give customers of authorised financial services firms some rights of complaint and compensation if a firm is unable to settle a claim against it. The Financial Services Compensation Scheme (FSCS) protects the deposits of customers of authorised banks, building societies and credit unions in the event of their insolvency. The FSCS also applies to authorised financial services firms engaged in regulated activities such as insurance, investment and mortgages. It does not apply to any activities of a society.

The Financial Ombudsman Service, set up under the Ombudsman Scheme, helps to settle disputes between consumers and authorised financial services firms. Most cases are settled informally. If an Ombudsman makes a final decision that is accepted by the consumer, it is binding on both parties and enforceable in court. A consumer purchasing community shares has no right to use the service to resolve a dispute regarding community shares.

Section 4.2 recommends that all share offer documents should make it clear “that anyone buying community shares could lose some or all of the money they invest, without the protection of the government’s Financial Services Compensation Scheme, and without recourse to the Financial Ombudsman Service. This warning should be prominently positioned in all offer documents and expressed in plain English. “

## 7.4 CONTRACT LAW

Despite the absence of statutory regulation, a society offering community shares is still subject to contract law. Those communicating information about an investment opportunity or advising people about an offer will have to pay damages, and may have the investment contract set aside, if the torts of deceit or negligent misrepresentation have been committed, if a contract term is broken, or if the Misrepresentation Act 1967 applies. This may well be the case if losses were incurred by an investor who relied on the document, information, or advice in deciding to enter the investment contract and if the loss was due to a false or misleading statement of fact or any negligent statement. It is therefore vital that all information provided in documentation, on videos or websites, at public meetings, and in any other communications with potential investors is accurate, is not misleading, and is the result of careful consideration.

The lack of statutory regulation, and consequently more limited protection for investors, only strengthens the case for developing robust standards of voluntary regulation and good practice; a responsibility that has been taken on by the Community Shares Unit.



## 7.5 FINANCIAL CONDUCT AUTHORITY

### 7.5.1 The Mutuels Team

The Mutuels Team at the FCA is the registrar of mutual societies, including co-operative and community benefit societies, building societies, friendly societies and credit unions. As registrar, it has the powers to cancel the registration of a society, as well as to register new societies.

The role of registrar was transferred from the Financial Services Authority to the FCA under the powers of the Financial Services Act 2012 (Mutual Societies) Order 2013. Schedule 1 Paragraph 5(1) says "*the FCA must maintain arrangements designed to enable it to determine whether persons are complying with requirements imposed on them by or under the legislation relating to mutual societies*".

This imposes a legal duty on the FCA to have systems in place to determine whether or not co-operative and community benefit societies are meeting their obligations under society law. Any society not fulfilling its duties under society law, as expressed in its registered rules, could have its registration cancelled (see Section 7.5.2). This could include matters connected to a society's share capital, so to this extent the FCA and its Mutuels Team have a responsibility to ensure that societies act within society law when making a community share offer.

### 7.5.2 Inspections and investigations

The Co-operative and Community Benefit Societies and Credit Unions (Investigations) Regulations 2014 gives the FCA the same powers to investigate the affairs of a society as are currently held the Secretary of State to investigate companies under Part 14 of the Companies Act 1985. This includes the powers to direct a society to produce documents or information, or to authorise an investigator to enter the premises of a society to obtain such evidence. It is an offence to destroy or falsify information relating to the society's affairs. At the request of a minimum of ten members, who also agree to underwrite the cost of the task, the FCA can appoint a professional person to inspect and report on the financial affairs of a society. The FCA has the powers to order that the costs of the inspection to be borne by the applicants, the society, or its officers, after the outcome of the inspection is known.

Section 106 of the Co-operative and Community Benefit Societies Act 2014 gives the FCA powers to appoint inspectors to investigate the affairs of the society, if so requested by at least 10% of the members of the society, or at least 100 members, whichever is the smaller number. The inspectors can be instructed to report to the FCA or a special meeting of the society. The applicants are required to underwrite the cost of the investigation, subject to the FCA determining who should bear the cost when the outcome of the investigation is known. The inspectors have far-reaching powers to inspect the accounts and documents of the society, and to question officers, employees and members of the society under oath.

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### 7.5.3 Sanctions

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The failure of a society, its officers, management committee members or senior employees to abide by society legislation, its own rules, or any other legal duties borne by the society, can lead to civil or criminal sanctions being imposed. This can include the loss of office for officers and management committee members, and ultimately their disqualification.

On 6 April 2014 the Company Director Disqualification Act 1986 was extended to cover societies. This means that a management committee member of a society can be disqualified from serving as a member of a management committee of any society, or being the director of a company, for a period specified by a court order, or some other form of legally binding undertaking.

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### 7.5.4 Suspension and cancellation of registration

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Sections 5 to 8 of the Co-operatives and Community Benefit Societies Act 2014 give the FCA the power to suspend or cancel the registration of a society. This power of cancellation is mainly applied to societies that repeatedly fail to submit an annual return and accounts. Failure to submit an annual return and accounts to the FCA no later than seven months after the end of a society's year end is a criminal offence punishable by a fine of up to £1,000 per offence.

The FCA can also suspend or cancel the registration of a society which is failing to satisfy the conditions of its registration as either a co-operative society, community benefit society or pre-2014 registered society. This can include societies that have obtained their registration by fraud or mistake, exist for illegal purposes, or are wilfully violating the provisions of 2014 Act in some other way.

The procedure for suspending or cancelling the registration of a society is set out in the 2014 Act. This includes details of the notice the FCA must give to a society of its intention to cancel or suspend registration, and the rights of a society to appeal against the FCA's actions.

A society can voluntarily choose to cancel its registration. The procedure for this is explained in Section 2.9.5. Cancellation must not be used to avoid insolvency proceedings.

## 7.6 COMMUNITY SHARES UNIT GUIDANCE

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### 7.6.1 Introduction

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The Community Shares Unit provides good practice guidance and promotes high standards of voluntary regulation among societies issuing community shares. It does this through the publication of this Handbook, an activity overseen by a technical committee, originally established by the FCA, and that now includes representation from HM Treasury, the Charity Commission, HMRC and the Department for Communities and Local Government.

In order to further promote good practice the Community Shares Unit has introduced a Standard

Mark for share offer documents that comply with the guidance contained in this Handbook. The Mark is awarded by licensed practitioners to the offer documents of societies that are assessed to be compliant with established criteria of good practice.

In developing these arrangements, the Community Shares Unit is mindful of the following underlying principles of voluntary regulation:

- **Proportionate and low cost:** The demands placed on a society making a community share offer should be proportionate to the scale of the offer, and not be overly burdensome. Small offers of less than £50,000 are not expected to engage with the Compliance Mark. The cost of compliance should be kept as low as possible, and be proportionate with the amount of capital to be raised.
- **Simple:** Community share offers are targeted at local communities, mostly made up of unsophisticated investors who are unlikely ever to have directly purchased shares before, or to have used the services of an independent financial adviser. All documentation aimed at the general public should be simple, accessible and comprehensible without expert advice.
- **Open:** Societies should be fully transparent about all aspects of their business and share commercial data with other societies operating in the same sector in order to learn from one another. The sharing of business data and market intelligence should underpin the open appraisal of offer documents.
- **Practical and developmental:** Guidance should be easy to understand and to implement. It should be based on evidence of what works for other societies and communities. The guidance should enable societies to become more resilient and sustainable as enterprises.
- **Practitioner support:** Responsibility for community share offers rests with the management committee of the society making the offer, supported by practitioners who have been assessed as competent. Practitioners should be encouraged to develop their competencies in supporting community share offers.

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## 7.6.2 The Community Shares Standard Mark

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The purpose of the Standard Mark is to create and maintain public confidence in community share offers, by ensuring a consistent approach to standards by all participating societies and practitioners.

The Mark is awarded to share offers that comply with the guidance in the Community Shares Handbook and satisfy the assessment criteria for the Mark. These criteria address the offer document, application forms, rules and business plan of a society, where relevant. The assessment is carried out by a licensed practitioner, using an assessment template devised and maintained by the Community Shares Unit.

From a consumer protection perspective, the aim of the Standard Mark is to ensure that community share offers meet the following standards:

- The offer document and application form are easy to understand.
- Consumers are provided with all the facts they need to make an informed decision.
- The facts are supported by the annual accounts and/or business plan for the society.
- Nothing in these documents is purposefully incorrect, confusing or misleading.

Societies are asked to sign a Code of Practice requiring them, among other things, to give the public a right of complaint to the Community Shares Unit. The Community Shares Unit will remove the Mark from offers where the society is shown not to be complying with the Code of Practice.

The Mark is not a guarantee that the business will be a success. Nor is it intended to be a form of due diligence or investment advice. Consumers should still be warned that they could lose some or all of the money they invest, and that they have no rights to statutory compensation or complaint.

The Mark is the property of the Community Shares Unit, which is responsible for licensing practitioners and monitoring their assessments. There is a code of conduct for community share offers carrying the Standard Mark that includes a public right of complaint overseen by the Community Shares Unit. The Code of Practice sets standards for the promotion and administration of community share offers by societies. The Community Shares Unit has the ultimate sanction of removing the Mark from a society's offer document, and cancelling a practitioner's licence.

The Community Shares Standard Mark is promoted to the public in the publication, *Investing in Community Shares*, which participating societies are encouraged to list on their websites and refer to in their offer documents.

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### 7.6.3 Practitioner licensing

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The term practitioner is used to describe a person who provides support to new and established societies developing a community share offer. This support can take a variety of forms, ranging from reviewing offers for the Standard Mark, through to advising societies on the development of governance arrangements, community engagement plans and investment strategies, designing and writing offer documents and business plans, and in some cases, providing expert technical support in sector specialisms. Many practitioners have hands-on experience as entrepreneurs and management committee members of societies that have made successful community share offers.

The community shares practitioner licensing scheme was developed by the Community Shares Unit to grant competent practitioners the powers to award the Community Shares Standard Mark to share offers that meet the required standard. Practitioners undergo a competency-based assessment process, focusing on their community shares support work with a client society. Practitioners are required to conduct a further three Standard Mark reviews under the supervision of the Community Shares Unit, before they are licensed to issue the Mark in their own right. Licenced practitioners are asked to agree to a Code of Practice, which includes a requirement to avoid any conflicts of interest in awarding the Mark. This means that a practitioner cannot award the Mark to a share offer they have been involved in writing, or where they are on the management committee of the society making the offer.

The Community Shares Unit maintains a directory of licenced practitioners on its

website, highlighting the practitioners' profiles, sector specialisms and operational regions.

## 8 TAX TREATMENT

### 8.1 INTRODUCTION

This section looks at the tax treatment of societies and their members, focusing on where this differs significantly from the tax treatment of companies and their shareholders, and where taxation may be an important factor in the offer of community shares. Some forms of tax, such as Value Added Tax (VAT), where companies and societies are largely treated alike, are not addressed in this section. Other forms of tax, notably Income Tax, are only addressed in areas where the tax treatment of co-operative and community benefit societies and their members differs significantly from that of companies and their shareholders. This section also outlines four forms of income tax relief applicable to community shares: Enterprise Investment Scheme (EIS); Seed Enterprise Investment Scheme (SEIS); Social Investment Tax Relief (SITR); and Community Investment Tax Relief (CITR).

This section is not a comprehensive guide to the tax treatment of societies and their members. Its aim is to alert community shares practitioners to relevant matters, and direct them towards the more detailed guidance available in the HMRC Manuals and Helpsheets (See [www.hmrc.gov.uk](http://www.hmrc.gov.uk)). HMRC also provides dedicated telephone helplines for advisers, and in more complex cases will respond to requests for Non-Statutory Business Clearance, which is written confirmation of HMRC's view of the application of tax law to a specific transaction or event.

### 8.2 BUYING AND SELLING SHARES

Stamp duty and stamp duty reserve tax are taxes payable on the transfer of shares from one party to another. These charges do not apply to a new issue of shares by an enterprise, or to the purchase of non-transferable, withdrawable shares in a society. However, stamp duty is payable on transferable shares of a society when these are transferred between one person and another, unless the purchaser is eligible for tax relief or exemption.

The sale of shares can be liable to capital gains tax if a profit or gain is made by the seller. But as community shares can only be withdrawn at or below the price paid for the shares, no capital gain is possible, and there is no liability to capital gains tax. Any losses on the withdrawal of share capital from a society cannot be used to offset capital gains made elsewhere (see HMRC Helpsheet 286).

### 8.3 INCOME TAX

In most circumstances, members of a society must pay income tax on all their earnings and receipts from the society (See HMRC Self-Assessment Claims Manual SACM). In the context of community shares, these receipts will normally be in the form of interest on share capital. Interest on share capital is a deductible expense for corporation tax purposes, but the receipt is liable for income tax payable by the member. HMRC does not normally require societies to deduct income tax on share interest paid to members; but it is the responsibility of members to declare their gross earnings and receipts to HMRC, including any such share interest payments. Societies are obliged

to inform HMRC of any gross interest payments to members on shares or loans to the value of £250 or more per annum, by providing the names and contact details of these members. If share interest is paid to members who are non-UK residents, the society must deduct income tax from the payment (see HMRC manual SAIM 9200).

However, interest paid on withdrawable shares in societies is eligible for the new Personal Savings Allowance (PSA), introduced on 6 April 2016. The PSA will apply a new 0% rate for up to £1,000 of savings income received by a basic rate (20%) taxpayer, or up to £500 of savings income for a higher rate (40%) taxpayer. The PSA will not apply to savings income received by 45% additional rate taxpayers.

If a member already pays tax through a PAYE code, and their total untaxed income from savings and investments is less than £2,500, they can request that any tax they owe is collected through their tax code. If their income from these sources is £2,500 or more they will need to complete a tax return.

A co-operative society may also pay members a dividend (also referred to as a discount, bonus, or rebate) based on their transactions with the society. Such payments are a deductible expense for corporation tax purposes. However, it may or may not be a taxable income for the member. This will depend on the nature of the dividend and the nature of the transactions upon which the dividend is based. For co-operative societies where the dividend is based on retail purchases of members, the dividend is effectively a discount on the purchase price and is not treated as taxable income. But for a co-operative society where the dividend is based on sales or purchases by members, such as members of an agricultural co-operative, then the dividend is a receipt of the member and is taxable income.

## 8.4 ENTERPRISE INVESTMENT SCHEME

The Enterprise Investment Scheme (EIS) was introduced in 1994 to encourage equity investment in small unlisted enterprises carrying on a qualifying trade in the UK. (For detailed guidance see HMRC Venture Capital Schemes Manual VCM10000 and HMRC Helpsheet HS431.)

Eligible enterprises can use the Scheme to attract up to £5m of equity investment in any twelve-month period. It provides tax relief for individuals (not corporate bodies) and is worth 30% of the cost of the shares, to be set against the individual's income tax liability for the tax year in which the investment is made. The shares must be new and additional capital and must be held by the individual for at least three years after they were issued or the enterprise started trading, whichever is longer. The capital raised must be used to finance the qualifying business activity. Early withdrawal of share capital by a member will result in a loss of tax relief for that member, but it would not jeopardise the tax relief of other members, especially if the amount withdrawn was not substantial, taken to mean less than £1,000. However, if the society was routinely allowing members to withdraw share capital within three years, including members who did not receive EIS, this could jeopardise the eligibility for tax relief of all members. The maximum amount of individual tax relief that can be claimed in any one tax year is currently £300,000.

Although EIS is primarily targeted at private companies limited by shares, societies are also eligible,

subject to the same restrictions that are imposed on companies, requiring share capital to be fully at risk, without any guaranteed or pre-arranged exits for the investor. This means that a society must have the powers to suspend or refuse applications to withdraw share capital. HMRC recognises that withdrawable shares are not the same as redeemable shares, and does not treat them as such, as long as the society has these powers.

The Finance Act 2015 introduced a number of reforms to EIS, including new qualifying criteria to limit relief to investment in “knowledge intensive” enterprises within ten years of their first commercial sale, with all other qualifying enterprises required to be within seven years of their first commercial sale. This will not apply to enterprises where the investment represents more than 50% of turnover averaged over the preceding five years. It also introduced a new restriction preventing the investment funds from being used to acquire existing businesses or business assets. Taken together, these new criteria mean that many community led buy-outs of existing enterprises such as shops, pubs and football clubs will no longer be eligible for EIS.

Enterprises engaged in non-trading activities, such as investment deals or property rental, are not eligible for EIS. This means that societies that acquire assets, such as pubs, which are leased to a tenant, do not qualify for tax relief. Similarly affected are societies that raise capital to invest in managed workspaces, or community buildings that are rented or leased to user groups. To qualify for EIS, the non-trading income of a society must not exceed 20% of its total income.

Most trades qualify, but some do not and these are referred to as “excluded activities”. Among the excluded activities are some which are very popular with community enterprises, such as electricity and energy generation, farming, market gardening, woodland management, and property development. Also excluded are any activities that count as investment, not trade, such as property rental. Some activities such as room hire are more difficult to determine, especially where it is packaged with trading activities such as conference facilities or wedding receptions. In these cases, the VAT treatment of the activity may be helpful in determining whether it is a trading activity.

In March 2018 HMRC introduced an additional “risk-to-capital” condition in an effort to stamp out “capital preservation” schemes. HMRC will apply a principles-based test to ensure that the capital raised is genuinely being put at risk within the enterprise and not being preserved, for instance through the acquisition of property, or the retention of cash balances. Enterprises are now required to submit a full business plan as evidence of the risks to which the capital raised will be exposed. Advance assurance applications should emphasise the risks to capital highlighted in the risk register of the business plan.

There are also rules about the maximum size of the enterprise. It must employ fewer than 250 full-time equivalent employees and gross assets must not exceed £15m. The enterprise must be an independent entity and not controlled by another person or entity; it may have subsidiaries as long as they are all majority owned, or at least 90% owned if the EIS capital is to be invested in the subsidiary.

EIS is administered by the Small Company Enterprise Centre (SCEC) at HMRC. The SCEC is responsible for deciding whether an enterprise and its share issue qualify for the Scheme. It does this by checking that the enterprise’s accounts, governing document, business plan and other documentation relating to the share issue, comply with the requirements of the Scheme. The SCEC



operates an advance assurance scheme, whereby an enterprise can submit their plans and documents in advance, using the form EIS(AA), and the SCEC will advise on whether or not the proposed share offer is likely to qualify. Advance assurance applications can be made for any of the venture capital schemes, including Seed Enterprise Investment Scheme (SEIS) and Social Investment Tax Relief (SITR).

In 2018 HMRC introduced measures to reduce the number of “speculative” advance assurance applications it deals with, by requiring enterprises to provide evidence that they have identified potential investors in their scheme. It is not clear what evidence will satisfy HMRC that a scheme has community support, which could range from a list of pledged investors to less specific evidence of community engagement and support derived from community meetings, surveys and the like. The Office of Civil Society has obtained reassurances from HMRC that enterprises applying for SITR will be exempt from these requirements for the time being.

Advance assurance is not mandatory; an enterprise and its investors can still qualify for the scheme after the shares have been issued, but potential investors are likely to take comfort from advance assurance when deciding whether to invest.

Connected persons are not eligible for EIS tax relief. This includes anyone who is an employee, paid management committee member, or large shareholder (defined as holding more than 30% of the share capital) of the enterprise, or anyone who is an associate of such a person. An associate is defined as a spouse or civil partner, lineal ancestor or descendant, a business partner, or certain persons with whom the individual has connections through a trust. Joint shareholders (see Section 3.2.4) are treated as though they invested an equal amount for tax relief purposes, even if they have not contributed equally to the joint purchase. If shares have been bought as a gift, it is the recipient, not the purchaser, who receives the tax relief (see Section 5.9). Offer documents should make it clear that applicants should check they are eligible for tax relief before relying on it. HMRC provide guidance on this matter through its helpsheet HS431.

Regardless of whether advance assurance was obtained or not, the enterprise must submit a compliance statement (form EIS1) to the SCEC after the shares have been issued and the enterprise has been trading for a minimum of four months. If the SCEC accepts that the enterprise, its trade, and the shares all meet the requirements of the scheme, it will issue form EIS2 to that effect, and supply sufficient forms EIS3 for the enterprise to send to the investors so they can claim tax relief.

In order to claim EIS tax relief investors must first obtain a form EIS3 from the enterprise they have invested in. The investor should use this form to claim the tax relief for the year in which the shares were issued, or it can be carried back to the previous tax year. If the investor normally pays income tax by PAYE and the total tax relief is less than £5,000 then the tax relief can be claimed in one of two forms: either as an adjustment to the PAYE code if the tax relief is being claimed in the current financial year, or as a carried back claim against income tax on the previous year, in which case the investor will receive the tax relief as a lump sum repayment. If the investor is claiming more than £5,000 in tax relief and currently pays income tax through PAYE, they will be asked to complete a Self Assessment tax form. If the investor already completes an annual Self Assessment form then they should claim the tax relief the next time they submit this form.

Investors can also benefit from capital gains tax deferral relief if they are reinvesting capital gains

made elsewhere into an EIS eligible enterprise.

## 8.5 SEED ENTERPRISE INVESTMENT SCHEME

The Seed Enterprise Investment Scheme (SEIS) aims to encourage equity investment in new small enterprises. (For detailed guidance see HMRC Venture Capital Schemes Manual VC30000 onwards.) The rules for SEIS have been designed to mirror those of EIS because it is anticipated that enterprises may want to go on to use EIS after an initial investment under SEIS. The same rules apply to the definition of qualifying trades, restrictions on connected persons, relationships with subsidiary entities, and the period shares must be held for. The connected person rules mean that the maximum individual investment under SEIS is limited to 30% or £45,000. There are a number of key differences between SEIS and EIS. The enterprise must have been trading for less than two years when the SEIS shares are issued, it must have gross assets of less than £200,000 and it must have fewer than 25 employees. The maximum amount it can raise under SEIS is £150,000 and this figure is reduced further by any amount of state aid the enterprise may have received in the preceding three years. The tax relief available through SEIS is 50% and the annual maximum amount an individual can invest in SEIS shares is £100,000. Investors who are reinvesting gains are exempt from capital gains tax for half of the reinvested gain, up to the annual maximum of £100,000.

SEIS is administered by the SCEC at HMRC, using the same procedures as those for EIS. Enterprises can apply for advance assurance using the same application form as for EIS. Following the share issue, the enterprise must submit a compliance statement (using form SEIS1), but only after it has been trading for at least four months or it has spent at least 70% of the funds raised. If the SCEC is satisfied that the enterprise meets the requirements of the scheme, it will issue a certificate to that effect and supply the enterprise with SEIS3 tax relief claim forms for investors.

Societies seeking to raise more than £150,000 can offer both SEIS and EIS, with the first £150,000 raised qualifying for SEIS and subsequent amount qualifying for EIS. Any society planning to do this should make sure it has a robust procedure in place to identify the first £150,000 of investment, and this procedure should be made clear in the offer document.

## 8.6 SOCIAL INVESTMENT TAX RELIEF

Social Investment Tax Relief (SITR) was launched in April 2014 with the aim of encouraging investment in social enterprises by unconnected individuals. On 6 April 2017, the scheme was enlarged to allow up to £1.5m of qualifying investments a social enterprise can receive under this scheme within seven years of its first commercial sale. For older enterprises, the state aid de minimus principle still applies, limiting qualifying investments to the sterling equivalent of €344,000 in any three-year rolling period.

The rules for SITR mirror those of EIS and SEIS in some but not all areas. For instance, the rules regarding connected persons and subsidiary entities are very similar, whereas the capital-at-risk

rule does not apply to SITR, making it more suitable for societies with low-risk capital development plans

As with EIS and SEIS, the social enterprise must be engaged in a qualifying trading activity. This means that social enterprises solely reliant on voluntary, donated or investment income are not eligible. But a social enterprise with a wholly or majority owned trading subsidiary is eligible, as long as the funds raised are invested in the trading activity. There are some minor differences in the definition of qualifying trading activities. Under the changes introduced in April 2017 all energy generation activities, leasing and the hiring of assets, the provision of financial services to social enterprises, and the operation or management of nursing or residential homes, have been excluded. But the provision of legal and accountancy services, and the operation or management of hotels or comparable establishments remain as eligible trading activities. The government has also said it will introduce an accredited scheme for the provision of affordable social care, that will be an eligible trading activity for SITR purposes.

There are major differences in the type of enterprise that qualifies for SITR and the nature of the investments. SITR is only available for investment in social enterprises. SITR defines social enterprises as charities, community interest companies and certain types of community benefit societies. At the heart of this definition is the requirement that the enterprise has a statutorily defined asset lock, so only community benefit societies with the prescribed asset lock (see Section 2.4) fit the definition, along with charitable community benefit societies, where the asset lock is determined by charity law. Co-operative societies are not included in this definition because there is no statutory asset lock for this type of society. Other eligibility criteria include a requirement that the social enterprise must not have more than 250 employees or more than £15m in gross assets.

SITR is available for both debt and equity investment in social enterprises. The eligibility of debt finance makes SITR radically different from EIS and SEIS, both of which only apply to equity investment. To qualify for SITR, debt finance must be unsecured and there must be no pre-arranged exit for the investor for at least three years. It must be subordinate to all other debts held by the social enterprise and not attract more than a commercial rate of interest.

Like SEIS, the maximum amount an older social enterprise can raise is restricted to the €200,000 state aid de minimus limit. But unlike SEIS, where the maximum amount that can be raised is fixed at £150,000, SITR uses a formula to calculate the maximum amount, based on the value of the tax reliefs, less any state aid already received by the social enterprise during a rolling three-year qualifying period. At current tax relief rates, this works out as €344,827, or just over £250,000.

Like EIS, SITR is a tax relief for individuals (not corporate bodies) and is currently set at 30%. The maximum amount an investor can invest in SITR schemes is £1m per annum. Individuals are not eligible to invest in a social enterprise under SITR if they have previously invested in the same enterprise, and these investments were not made under SITR or one of the other tax relief schemes covered in this section of the handbook. Connected persons, defined in a similar way as for EIS and SEIS, are not eligible for SITR, including any investor with more than 30% of the total loan capital or voting rights. Investors are eligible for capital gains hold-over relief on gains reinvested in SITR schemes, and also for capital gains disposal relief on gains made on qualifying SITR investments.

SITR is not available on any investment for which the investor has already received SEIS, EIS or

Community Investment Tax Relief. But a social enterprise can offer SITR on debt finance in combination with SEIS for equity finance, as long as cumulative tax relief benefit does not exceed the maximum restrictions applicable to each scheme; although, in the case of older social enterprises, these restrictions are based on de minimus state aid, and this has been interpreted slightly differently for each scheme, so HMRC may need to determine which investment was made first in order to work out how much can be invested in each scheme. A social enterprise can also offer SITR on loan capital at the same time as offering EIS on share capital; these schemes are independent of each other, and EIS is not subject to de minimus state aid rules, although it is subject to enterprise age rules.

SITR is administered by the SCEC at HMRC. The arrangements are similar to those for SEIS and EIS, including the provisions for advance assurance.

## 8.7 INHERITANCE TAX

Shares in unlisted companies qualify for business relief from inheritance tax, where these shares have been passed on during a person's lifetime or as part of their will. For people who died after 6 April 1996 business relief on shares in unlisted companies is 100%. Business relief from inheritance tax may extend to withdrawable shares in societies, as long as the society is engaged in a trade which it is carrying on for the purposes of making a gain. Evidence of this will be expressed in the objects of the society, and in its behaviour, for instance, through the payment of interest on share capital. Business relief is not available if the trade is carried on otherwise than for gain; this might apply to some charitable community benefit societies or societies that have stated an intention never to pay interest on share capital. (For detailed guidance see HMRC Inheritance Tax Manual IHTM)

## 8.8 COMMUNITY INVESTMENT TAX RELIEF

Community Investment Tax Relief (CITR) is designed to encourage individual and corporate investment in accredited Community Development Finance Institutions (CDFIs), which in turn must invest the capital in small and medium sized enterprises based in, and/or serving, the most disadvantaged communities in the UK. Investment can be in the form of debt or equity, and could include withdrawable share capital in CDFIs that are structured as societies. CDFIs are accredited by the Department for Business Innovation and Skills for the purposes of CITR.

The tax relief, which is worth 25% of the total invested spread over 5 years, is available against either income tax or corporation tax. State aid de minimus rules apply to the beneficiary enterprises, which must not receive more than €200,000 in aid over any three year period.

Detailed guidance on CITR is available in the HMRC Community Investment Tax Relief Manual CITM1000 and Helpsheet HS237.

## 8.9 TAX TREATMENT OF CHARITABLE COMMUNITY BENEFIT SOCIETIES

Charitable community benefit societies in Scotland are registered with and regulated by the Scottish Charity Regulator, and enjoy the same tax treatment as all other registered charities. In England and Wales, charitable community benefit societies with exempt charity status are subject to the same fiscal treatment as registered charities. Such societies are recognised as exempt charities by HMRC and are given an HMRC charity reference number. Charities benefit from a wide range of exemptions and reliefs, including gift aid, corporation tax relief and some exemptions from VAT.

HMRC provides detailed guidance on VAT for charities and other forms of not-for-profit organisations including charitable community benefit societies. There are special VAT exemptions for charities active in amateur sports, education, cultural events and activities, and welfare services. Welfare advice or information is subject to a reduced VAT rate of 5%.

Gifts, grants and donations to charitable community benefit societies may qualify for Gift Aid if the voluntary income is received from an individual who is a UK taxpayer. Gift Aid donations are assumed to have been made by donors who have already paid the basic rate of tax on the donation, and qualifying charities can reclaim this tax deduction from HMRC on its gross equivalent; the amount before the basic rate was deducted. Higher rate tax payers can reclaim the difference between the basic rate and the higher tax rate they pay on the gross donation to the charity.

Charitable community benefit societies are exempt from paying Corporation Tax on charitable trading profits, rental income, interest and capital gains. Donations used for charitable purposes are not liable for Corporation Tax. When a corporate entity makes a qualifying donation to a charity, the amount paid can be set against its profits for Corporation Tax purposes. This includes donations made by wholly-owned subsidiaries of charities, but it does not apply to any dividends paid by the subsidiary to the parent charity. Non-charitable community benefit societies are taxable in the normal way, as described in Section 8.10.

## 8.10 CORPORATION TAX

### 8.10.1 Introduction

Societies are subject to Corporation Tax on broadly similar terms to companies. Detailed guidance on how company taxation relates to societies is available in the HMRC Company Taxation Manual CTM40500. Other than the exemptions that exist for charitable community benefit societies (see Section 8.9), societies need to be aware of the tax treatment of co-operative societies engaged in mutual trading, and the circumstances under which a society may be considered dormant for Corporation Tax purposes.

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## 8.10.2 Mutual trading

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Mutual trading is where members form a co-operative society in order to conduct trade for their mutual benefit. Examples include purchasing co-operatives and marketing co-operatives, where members come together to buy or sell goods and services, using the co-operative as a conduit, or agent, for their trade. Any surplus generated from this trade belongs to members in proportion to the amount of trade they have conducted through the co-operative.

A co-operative society engaged in mutual trading is not liable for corporation tax on its surpluses, as long as it satisfies four essential requirements set down by HMRC. The first of these requirements is that any surpluses must go back to the members who contributed to that trade, and no one else. Community benefit societies cannot engage in mutual trading because such societies are required to be of benefit to the broader community and not just members. However, co-operative societies can satisfy this requirement if their trading activities are restricted to members only and the society in question acts as the agent, not the principal, in all transactions.

The other three requirements are that contributors to and participants in the surplus must be identical, that the return of surplus contributions must be proportionate to those contributions, and that members must control any common funds. The last of these requirements accommodates the co-operative principle that part of any reserves must be indivisible if members have control over these common funds.

Mutual trading could be relevant to any co-operative society that trades exclusively with its members, and does not trade with non-members or accounts for trade with non-members on a separate basis. This could include a consumer co-operative where customers must become members of the co-operative before they can use its services.

HMRC interprets mutual trading in a slightly different way when it involves a members' club providing social and recreational activities. Any club incorporated as a co-operative or community benefit society is regarded as a members' club for tax purposes. When members buy goods and services through the club, and if these activities are restricted to members only, and any surplus arising from these activities belongs to members, then HMRC do not regard this trading, but merely the consumption or use of the members' own property.

For detailed guidance on mutual trading see HMRC Company Taxation Manual CTM40950.

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## 8.10.3 Dormant for Corporation Tax purposes

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A small number of community benefit societies have been deemed by HMRC to be dormant for Corporation Tax purposes. This means they are not liable to pay Corporation Tax on their trading profits.

There are a number of reasons why HMRC may consider a society to be dormant for Corporation Tax purposes. These include small societies with a Corporation Tax liability of £100 or less, new societies that have not started trading, established societies that have ceased trading, or societies that have been established for non-trading purposes. This could include societies that have been

established to own assets, such as land and buildings, but if such societies derive an income or capital gain from these assets, they may still be liable for Corporation Tax. In most cases any society engaged in a business activity will usually be liable to Corporation Tax, even if this activity is carried on for purposes other than for gain.

Determining whether a society is dormant for Corporation Tax purposes can be very difficult. HMRC will assess each case on its own merits and grant concessional exemption to any society it deems to be dormant for Corporation Tax purposes.